GART09

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Auditor's Reports

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Interactive Self-study CPE

Companion to PPC's Guide to AUDITOR'S REPORTS

TABLE OF CONTENTS

To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

EXAMINATION INSTRUCTIONS, ANSWER SHEETS, AND EVALUATIONS

INTRODUCTION

Companion to PPC's Guide to Auditor's Reports consists of three interactive self-study CPE courses. These are companion courses to PPC's *PPC's Guide to Auditor's Reports* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **October 31, 2010**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Course[s]

Each course is divided into lessons. Each lesson addresses an aspect of auditor's reports. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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COMPANION TO PPC'S GUIDE TO AUDITOR'S REPORTS

COURSE 1

The Standard Auditor's Report and Internal Control Reporting (GARTG091)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course provides an overview of the standard auditor's report. Lesson 1 discusses the auditor's standard report on GAAP financial statements of a corporate entity for a single period. Lesson 2 covers identifying and evaluating control deficiencies, communicating significant deficiencies in internal control identified as part of the audit, and reports on the processing of transactions by service organizations.
PUBLICATION/REVISION DATE:	October 2009
RECOMMENDED FOR:	Users of *PPC's Guide to Auditor's Reports*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of auditing
CPE CREDIT:	6 QAS Hours, 6 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
FIELD OF STUDY:	Auditing
EXPIRATION DATE:	Postmark by **October 31, 2010**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Elements of the Auditor's Standard Report

Completion of this lesson will enable you to:

- Describe the different elements of an auditor's report.
- Discuss the purpose of the various paragraphs in an auditor's report.

Lesson 2—Reporting on Internal Control

Completion of this lesson will enable you to:

- Recognize control deficiencies.
- Discuss significant deficiencies in internal control identified as part of the audit.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
Tax & Accounting—R&G
GARTG091 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

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Lesson 1: Elements of the Auditor's Standard Report

INTRODUCTION

This lesson discusses the auditor's standard report on GAAP financial statements of a corporate entity for a single period.

Learning Objectives:

Completion of this lesson will enable you to:
- Describe the different elements of an auditor's report.
- Discuss the purpose of the various paragraphs in an auditor's report.

THE STANDARD REPORT

Reports on Audited Financial Statements

The standard report on audited financial statements for a single period that are prepared in conformity with GAAP is illustrated in SAS No. 58, *Reports on Audited Financial Statements*, at AU 508.08. The standard report consists of three paragraphs—an introductory paragraph, a scope paragraph, and an opinion paragraph—and is illustrated on the right side of Exhibit 1-1, while the left side of the exhibit presents the report elements.

The Title

SAS No. 58 (AU 508) requires the auditor's report to be titled and the title to include the word *independent* to distinguish the report from representations of management (i.e., the financial statements) or internal auditors. Including the word *independent* in the title also emphasizes a characteristic of the auditor's work that might not otherwise be apparent.

A minor point, but of interest to some, is the placement of the apostrophe in *Auditor's*. This course uses singular possessive punctuation. The plural possessive title *Auditors'* is reserved for situations when two different accounting firms (firm X and firm Y) each issue a separate opinion on the financial statements, e.g., a successor and predecessor auditor. Other firms use the plural possessive *Auditors'* regardless of the circumstances. You should use the punctuation preferred by your firm.

Exhibit 1-1

The Standard Report

Report Elements	**Report Text**
The Title	INDEPENDENT AUDITOR'S REPORT
Addressing the Report	To the Board of Directors and Stockholders of ABC Company
Statement That the Financial Statements Were Audited Name of Entity Type of Legal Entity Date of the Financial Statements Identification of the Financial Statements Statement of Management Responsibility Statement of Auditor Responsibility	(introductory paragraph) We have audited the accompanying balance sheet of ABC Company (a Texas corporation) as of [at] December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.
Generally Accepted Auditing Standards Statement about Reasonable Assurance Description of the Audit Process Reasonable Basis for Opinion	(scope paragraph) We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.
Identification of the Financial Statements Present Fairly In All Material Respects Financial Position Results of Operations Cash Flows Company Name Dates Generally Accepted Accounting Principles	(opinion paragraph) In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of [at] December 31, 20X1, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.
Firm's Signature	Firm's signature City, State
The Date of the Auditor's Report	February 15, 20X2

* * *

Addressing the Report

As discussed in SAS No. 58 at AU 508.09, the auditor's report on a corporate entity's financial statements generally should be addressed to the company whose financial statements are being audited or to its board of directors or stockholders. The terms "shareholders" or "shareowners" may be substituted for "stockholders." (It is preferable to use the term that is consistent with the company's articles of incorporation.) It also is common practice to include the city and state in the address (but not the street address or post office box number). Examples of report addresses for corporations follow.

- To the Board of Directors
  XYZ Corporation
  Shreveport, Louisiana

- To the Stockholders
  XYZ Corporation
  Jackson, Mississippi

- To the Board of Directors and Stockholders
  XYZ Corporation
  Fort Worth, Texas

In the case of many closely held companies, it may be appropriate to address the report to a specific individual; for example:

- Mr. T. Wise, President
  Wise Manufacturing Company
  New York, New York

Occasionally, auditors are retained to audit the financial statements of an entity that is not a client. In those cases, the report should be addressed to the client and not to the board of directors or shareholders of the company whose financial statements are being audited.

The auditor's report on the financial statements of a subsidiary is normally addressed to the parent company rather than to the board of directors of the subsidiary.

Auditors generally do not use any form of salutation, such as "Gentlemen" or "Dear Sir."

Reference to the Auditor's Report in the Financial Statements

Unlike compiled or reviewed financial statements, audited financial statements are not required to refer to the auditor's report. For example, a reference such as "The accompanying notes and auditor's report are an integral part of these financial statements" would be inappropriate, because financial statements are the representations of management. As such, the independent auditor's report cannot be an integral part of the financial statements, and it is inappropriate to include it by reference. A reference such as "See accompanying notes and auditor's report," although not required, would be acceptable.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following statements of auditing standards provides for a new standard auditor's report?

   a. SAS No. 58.

   b. SAS No. 95.

   c. SAS No. 102.

   d. SAS No. 103.

2. Listed below are elements of the auditor's report. Name two report elements belonging in the report text of the scope paragraph.

i. Description of the audit process.

ii. Reasonable basis for opinion.

iii. Date of financial statements.

iv. Statement of auditor responsibility.

v. Cash flows.

   a. iv, v.

   b. i, ii.

   c. iii, iv.

   d. iii, v.

3. Which of the following report addresses is the most common way to address a company whose financial statements are being audited?

   a. To the Board of Directors and Stockholders
      NBC Corporation
      102 Sunshine Ln.
      Miami, Florida

   b. To the Shareholders
      CBS Corporation
      Madison, Illinois

   c. FOX Corporation
      Ms. Jenny Rivers
      Oconee, Georgia

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following statements of auditing standards provides for a new standard auditor's report? **(Page 3)**

   a. SAS No. 58. [This answer is correct. The standard report on audited financial statements for a single period that are prepared in conformity with GAAP is illustrated in SAS. No. 58 Reports on Audited Financial Statements at AU 508.08.]

   b. SAS No. 95. [This answer is incorrect. SAS No. 95 (AU 150), *Generally Accepted Auditing Standards*, establishes three levels in the GAAS hierarchy.]

   c. SAS No. 102. [This answer is incorrect. SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards*, defines certain terminology used in the audit standards.]

   d. SAS No. 103. [This answer is incorrect. SAS No. 103 (AU section 339), *Audit Documentation*, requires auditors to adopt reasonable procedures to retain and access audit documentation for a period of time sufficient to meet the needs of their practice and to satisfy any applicable legal or regulatory requirements for records retention.]

2. Listed below are elements of the auditor's report. Name two report elements belonging in the report text of the scope paragraph. **(Exhibit 1-1 Page 4)**

i. Description of the audit process.

ii. Reasonable basis for opinion.

iii. Date of financial statements.

iv. Statement of auditor responsibility.

v. Cash flows.

   a. iv, v. [This answer is incorrect. The statement of auditor's responsibility should be stated in the introductory paragraph, while the cash flows is included in the opinion paragraph.]

   b. i, ii. [This answer is correct. The scope paragraph describes, in general terms, the steps auditors take to achieve reasonable assurance that the financial statements are free of material misstatement, and the scope paragraph also closes with a statements that the auditor's believe the procedures applied provide a reasonable basis for the opinion presented.]

   c. iii, iv. [This answer is incorrect. The date of financial statements is listed in the introductory paragraph, and the statement of auditor responsibility is to express an opinion on the financial statements based on the audit and emphasizes the limited nature of their function and differentiates the auditors' responsibility from that of management. This is also stated in the introductory paragraph.]

   d. iii, v. [This answer is incorrect. Dating of financial statements is included in the introductory paragraph and SFAS No. 95 requires a statement of cash flows whenever financial statement purport to present financial position. Cash flow is mentioned in the opinion paragraph.]

3. Which of the following is the most common way to address a report to a company whose financial statements are being audited? **(Page 5)**

   a. To the Board of Directors and Stockholders
   NBC Corporation
   102 Sunshine Ln.
   Miami, Florida

   [This answer is incorrect. Although it is common to include the city and state, it is not common to include the street address or post office box number.]

   b. To the Shareholders
   CBS Corporation
   Madison, Illinois

   [This answer is correct. Statements generally should be addressed to the company whose financial statements are being audited or to its board of directors or stockholders. The terms shareholders or shareowners can be substituted for stockholders.]

   c. FOX Corporation
   Ms. Jenny Rivers
   Oconee, Georgia

   [This answer is incorrect. It is appropriate for closely held companies to address the report to a specific individual, however, the individual's name should be on the first line and the name of the company should be on the second line.]

THE INTRODUCTORY PARAGRAPH

General Purpose

The introductory (or opening) paragraph of the standard report includes three elements:

- A statement that the financial statements identified in the report were audited.
- A statement that the financial statements are the responsibility of management.
- A statement that the auditors' responsibility is limited to expressing an opinion on the financial statements based on the audit.

Statement That the Financial Statements Were Audited

The statement that the financial statements were audited identifies the statements covered by the report. The report uses the word *audited* rather than *examined* because that word is considered more descriptive of the audit process and is better understood by users.

Name of Entity

The introductory paragraph should refer to the company's legal name. The name should be checked to the articles of incorporation for proper spelling and punctuation.

Type of Legal Entity

Although not required, some auditors indicate the type of entity, e.g., a corporation, in the introductory paragraph after the company's name. That designation may not be necessary when the type of entity is indicated by the company's legal name, e.g., XYZ Corporation or XYZ, Inc. A slightly different description also commonly used in practice is to indicate parenthetically the state of incorporation, e.g., (a Texas corporation).

Date of the Financial Statements

The first sentence of the introductory paragraph should identify the balance sheet date and the period of time covered by the statements of income, retained earnings, and cash flows. Dating of financial statements for interim and initial accounting periods is discussed later in this lesson.

Identification of the Financial Statements

The introductory paragraph should specifically identify the financial statements audited. The examples of auditor's reports in most Statements on Auditing Standards refer to the balance sheet or statement of financial position first, followed by the income statement or statement of results of operations and the statement of cash flows. However, as discussed in an AICPA Technical Practice Aid at TIS 9080.09, the order in which the financial statements are referred to in the auditor's report need not follow any prescribed pattern or even the order in which the financial statements are physically arranged. The standard report illustrated in Exhibit 1-1 may be used regardless of the order in which the financial statements are presented.

The minimum financial statement presentation required to present fairly a company's financial position, results of operations, and cash flows in conformity with GAAP is outlined in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*. According to SAS No. 29 (AU 551), basic financial statements include the following:

- a balance sheet,
- a statement of income,
- a statement of retained earnings or changes in stockholders' equity,
- a statement of cash flows,

- descriptions of accounting policies,
- notes to financial statements, and
- schedules and explanatory material that are identified as being part of the basic financial statements.

SFAS No. 130, *Reporting Comprehensive Income* (FASB ASC 220) also requires companies with certain components of comprehensive income to report total comprehensive income and its components in the basic financial statements. Note that schedules and explanatory material may be considered either as part of the basic financial statements or as supplementary information.

The standard report illustrated in SAS No. 58 (AU 508) refers to the balance sheet and related statements of income, retained earnings, and cash flows in the first sentence of the introductory paragraph. Such identification of the basic statements is appropriate unless there also have been changes during the period in other components of stockholders' equity. In those situations, a statement of stockholders' equity should be substituted for the statement of retained earnings, and the first sentence of the standard report should be modified as follows:

> . . . and the related statements of income, stockholders' equity, and cash flows . . .

A combined statement of income and retained earnings is sometimes used to disclose changes in retained earnings, in which case the first sentence of the standard report should be modified as follows:

> . . . and the related statements of income and retained earnings and cash flows . . .

If changes in retained earnings or stockholders' equity are disclosed on the face of the balance sheet or in a note to the financial statements, rather than presented in a statement, the balance sheet and income statement titles need not include any reference to retained earnings or stockholders' equity. In that situation, the first sentence of the standard report should be modified accordingly.

The financial statements identified in the introductory paragraph should be identical to the titles presented on the corresponding financial statements. A common deficiency is to refer to "statement of income" in the introductory paragraph, while the title used on the actual statement is "statement of operations." The term "statement of operations" may be used when the company suffers a loss to avoid a negative title such as "statement of loss," although "statement of income" also is acceptable and is used by many companies. Whatever titles are used, they must be consistent in both the auditor's report and on the corresponding financial statement.

Comprehensive Income. SFAS No. 130, *Reporting Comprehensive Income* (FASB ASC 220), establishes standards for reporting and displaying comprehensive income and its components in a set of basic financial statements. Comprehensive income includes two components: net income and other comprehensive income. Other comprehensive income includes items such as:

- foreign currency translation adjustments, and gains and losses from certain foreign currency transactions;
- adjustments in a company's minimum pension liability;
- unrealized gains and losses on available-for-sale securities; and
- changes in the fair value of certain derivatives that qualify as a cash flow hedge.

SFAS No. 130 (FASB ASC 220) is not applicable if a company has no items of other comprehensive income in any period presented. The Statement does not specify how to report other comprehensive income, except that is should be reported in a financial statement that is displayed with the same prominence as other financial statements. It allows three options. Comprehensive income may be displayed (a) in the income statement (after net income), (b) in a separate statement of comprehensive income (as long as the statement begins with net income), or (c) in a statement of changes in equity. As a result, the basic financial statements may include an additional financial statement, or the title of one of the existing statements may refer to the presentation of other comprehensive income. SFAS No. 130 (FASB ASC 220) does not specify the titles to be used for financial statements in which comprehensive income is presented. The financial statement titles in the auditor's report should match the titles on the corresponding financial statements.

For example, if a separate statement of comprehensive income is presented, the first sentence of the standard report may read as follows:

> . . . and the related statements of income, comprehensive income, retained earnings, and cash flows . . .

A combined statement of income and comprehensive income may be presented, in which case the first sentence of the standard report may read as follows:

> . . . and the related statements of income and comprehensive income, retained earnings, and cash flows . . .

Statement of Management Responsibility

The statement that the financial statements are the responsibility of the company's management gives users clear notice of management's overall responsibility for the financial statements. That statement is not, however, intended to change either management's present responsibility for the information presented or the relationship between management and the independent auditor. The statement is required even if auditors provide accounting services or otherwise assist management in preparing the financial statements.

Reference to Management Reports. Occasionally, a company's management will include a report that contains a statement acknowledging its responsibility for the presentation of the financial statements in a document containing the audited financial statements. An auditing interpretation at AU 9508.51–.52 states that such statements should not be elaborated on or referred to in the auditor's standard report. Thus, it is not acceptable to include a reference to the management report either in place of or in addition to the required statement about management's responsibility in the introductory paragraph of the auditor's report. Any such modification might lead readers to believe that the auditors are providing assurances about other matters usually addressed in management reports, such as management's responsibility for internal controls and other matters relating to financial reporting.

Statement of Auditor Responsibility

The statement that the auditors' responsibility is to express an opinion on the financial statements based on their audit emphasizes the limited nature of their function and differentiates the auditors' responsibility from that of management.

Reference to Another Auditor

The introductory paragraph may require modification when part of the audit is performed by another auditor. Normally, that circumstance occurs when consolidated statements are presented, and the parent is audited by firm X and one or more subsidiaries are audited by firm Y.

Audit Report of Sole Practitioner

The standard report in SAS No. 58 (AU 508) begins, "*We* have audited . . ." (Emphasis added.) The SAS does not specify appropriate report wording when a sole practitioner performs the audit. Likewise, Rule 505 ("Form of Organization and Name") of the AICPA's *Code of Professional Conduct* at ET 505 and its related interpretations and rulings do not discuss how sole practitioners should word their reports. However, it is recommended that sole practitioners word the report "*I* have audited . . ." and "In *my* opinion . . ." They believe that using the plural pronoun "we" while expressing an opinion on financial statements might imply that there are partners or shareholders in the CPA firm. Also, the signature on the report would be that of the individual practitioner.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

4. The fact that the financial statements are being audited should be identified in which of the following paragraphs?

   a. Introductory.

   b. Scope.

   c. Opinion.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

4. The fact that the financial statements are being audited should be identified in which of the following paragraphs? **(Page 10)**

   a. Introductory. [This answer is correct. Per guidance in SAS No. 58, the introductory paragraph should specifically identify the financial statements audited. However, according to AICPA Technical Practice Aid at TIS 9080.09, the order in which the financial statements are referred to in the auditor's report need not follow any prescribed order or pattern.]

   b. Scope. [This answer is incorrect. The scope paragraph states whether the financial statements are presented in accordance with generally accepted principles. Identification of financial statements audited is in another paragraph.]

   c. Opinion. [This answer is incorrect. The opinion paragraph makes reference to whether the financial statements have been fairly identified but does not identify which financial statements were audited.]

THE SCOPE PARAGRAPH

Generally Accepted Auditing Standards

The first sentence of the scope paragraph contains a statement that the audit was conducted in accordance with generally accepted auditing standards and identifies the United States of America as the country of origin of those standards (for example, "auditing standards generally accepted in the United States of America" or "U.S. generally accepted auditing standards"). Simply stated, the auditors state that they complied with the standards established by the auditing profession for the performance of an audit.

U.S. generally accepted auditing standards (GAAS) are discussed in SAS No. 1 (as amended by SAS No. 105 and 113) at AU 150. As a refresher, they are reproduced below.

General Standards

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

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

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

Standards of Field Work

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

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

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

Standards of Reporting

a. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).

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

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

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

The general standards are discussed in *AICPA Professional Standards* at AU 200 and deal with the qualifications of personnel assigned to an audit and the professional care exercised. The standards of field work are discussed in AU 300 and deal with the nature and adequacy of the work performed during the audit, including the confirmation of receivables and observation of inventories. The standards of reporting are discussed in AU 400 and AU 500 and deal with matters relating to the opinion expressed as a result of the audit. Materiality and relative risk underlie the application of all the generally accepted auditing standards, particularly the standards of field work and reporting.

Reference to Auditing Standards Board. When an audit of a nonpublic company is conducted in accordance with both GAAS and PCAOB auditing standards, the scope paragraph includes a reference to both "auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States)." While a reference to the Auditing Standards Board is not required in reports issued in connection with audits conducted in accordance with GAAS alone, it is believed that such a reference may be included if the auditor wishes to do so.

Statement about Reasonable Assurance

The scope paragraph of the report includes a statement that GAAS require audits to be planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement. SAS No. 104, *Amendment to Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures ("Due Professional Care in the Performance of Work")* clarifies that reasonable assurance is a high, but not absolute, level of assurance. That statement introduces the concept of materiality to the audit report and the auditors' responsibility for detecting errors or fraud.

Description of the Audit Process

The scope paragraph of the report also describes, in general terms, the steps auditors take to achieve reasonable assurance that the financial statements are free of material misstatement. The steps the report describes are as follows:

- Examining, on a test basis, evidence that supports the amounts and disclosures in the financial statements
- Assessing the appropriateness of the accounting principles used by management and of significant estimates made by management
- Assessing the appropriateness of the overall financial statement presentation

The discussion informs users that an audit is designed to provide reasonable assurance that financial statements are free of material misstatement. It also informs users about certain aspects of audits that may affect their understanding and interpretation of the auditor's report.

Optional Additional Language Related to Internal Control. The Sarbanes-Oxley Act and PCAOB standards require auditors of public companies to report on internal control over financial reporting in conjunction with the company's financial statement audit. The scope of an auditor's procedures in order to report on internal control over financial reporting is considerably greater under PCAOB standards than that required for an audit of financial statements in conformity with GAAS. Under PCAOB standards, auditors are required to perform procedures sufficient for them to express an opinion on the company's internal control over financial reporting. However, the procedures required by GAAS are intended to provide an auditor with a sufficient understanding of internal control to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures to be performed. An AICPA auditing interpretation at AU 9508.85–.88, *Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance with Generally Accepted Auditing Standards*, provides guidance to auditors of the financial statements of nonpublic entities who wish to clarify in their reports the fact that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as does an audit of a public company in accordance with PCAOB standards. In such circumstances, the auditing interpretation permits auditors to add clarifying language to the scope paragraph of the auditor's report. An example of the scope paragraph with the additional language italicized is as follows:

> We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. *An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.* An audit also includes examining, on a test basis, evidence

> supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The additional language suggested by the auditing interpretation at AU 9508.85–.88 deals only with the auditor's responsibility and conclusions regarding internal control. However, some auditors have questioned whether the guidance in SAS No. 58 regarding the content of auditor's report is broad enough to permit the inclusion of additional language regarding internal control.

Reasonable Basis for Opinion

The scope paragraph closes with a statement that the auditors believe the procedures applied provide a reasonable basis for the opinion presented. In the context of the sentences preceding it, that statement informs users that even though an audit has certain inherent limitations, the auditors have formed a positive conclusion about the scope of the audit work performed.

Departure from GAAS

Departures from GAAS are commonly referred to as "scope limitations" and occur when auditors are unable to apply customary auditing procedures or alternative auditing procedures.

PCAOB Auditing Standards

PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*, requires audit reports on issuers (public companies) to state that the audit was conducted "in accordance with the standards of the Public Company Accounting Oversight Board (United States)." The *PCAOB standards* referred to in the audit report on an issuer include not just audit standards, but also attestation, quality control, ethics, independence, and other PCAOB standards. PCAOB standards also require an audit of internal control over financial reporting in conjunction with the financial statement audit of an issuer.

The AICPA's Auditing Standards Board is the body authorized to establish performance and reporting standards for audits of the financial statements of nonpublic entities. On occasion, however, a nonpublic entity may request an auditor to perform an audit in accordance with PCAOB standards. When firms that are not required to follow PCAOB standards but do so voluntarily, for example, at a client's request, Rules 201 and 202 of the AICPA Code of Professional Conduct require a member who performs an audit of a nonpublic entity to comply with the standards promulgated by the Auditing Standards Board. In those circumstances, audits of nonpublic entities performed in accordance with the PCAOB standards must also be performed in accordance with GAAS.

Auditing Interpretation No. 18 of SAS No. 58 (AU 9508.89–.92), *Reference to PCAOB Standards in an Audit Report on a Nonissuer*, provides guidance when an audit of a nonpublic entity is performed in accordance with GAAS *and* the PCAOB auditing standards. In addition, the PCAOB has issued Staff Questions and Answers entitled *Audits of Financial Statements of Non-Issuers Performed Pursuant to the Standards of the Public Company Accounting Oversight Board*.

Auditing Interpretation No. 18. Auditing Interpretation No. 18 to SAS No. 58 notes that if an auditor performs an audit of a nonissuer in accordance with PCAOB auditing standards, the report may indicate that the audit was performed in accordance with both the AICPA Auditing Standards Board's generally accepted auditing standards and PCAOB auditing standards. In addition, the auditing interpretation notes that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control as does an audit performed in accordance with PCAOB standards, and the audit report for a nonpublic entity may include language to indicate that fact.

When an audit of a nonpublic company is conducted in accordance with GAAS and PCAOB auditing standards, the scope paragraph might be worded as follows (new language italicized):

> We conducted our audit in accordance with generally accepted auditing standards *as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States)*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. *The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.* An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

PCAOB Staff Q&A. The PCAOB Staff Questions and Answers on audits of nonissuer financial statements notes that an auditor that is not registered with the PCAOB may state in the audit report on a nonissuer that the audit was performed in accordance with only the *auditing* standards of the PCAOB when that is the case. In that case, the report reference to the *auditing standards of the Public Company Accounting Oversight Board (United States)* does not imply that—

- The audit included an audit of the issuer's internal control over financial reporting.
- The auditor complied with PCAOB or SEC independence rules.
- The auditor is subject to any laws to which the auditor would not otherwise be subject.
- The audit is subject to a concurring partner review.
- The audit is subject to PCAOB inspection.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. The following statement is included in which of the following paragraphs of the audit report?

   "We conducted our audit in accordance with auditing standards generally accepted in the United States of America."

   a. Introductory.

   b. Scope.

   c. Opinion.

   d. Conclusion.

6. The degree of responsibility the auditor is taking and the character of the auditor's work is listed under which of the following GAAS headings?

   a. General standards.

   b. Standards of field work.

   c. Standards of reporting.

7. If Agnes Auditor is reporting on internal control over financial reporting, the scope of Agnes' procedures is considered greater under which of the following?

   a. GAAS.

   b. ASB.

   c. PCAOB.

8. A statement declaring that the auditors believe the procedures applied provide a reasonable basis for the opinion presented is included at the end of which of the following paragraphs of the standard audit report?

   a. Introductory.

   b. Scope.

   c. Opinion paragraph.

9. Which of the following interpretations provides guidance on modifying the auditor's report when an audit of a nonpublic entity is performed in accordance with GAAS *and* the PCAOB auditing standards?

   a. Interpretation No. 14.

   b. Interpretation No. 17.

   c. Interpretation No. 18.

   d. Interpretation No. 32.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. The following statement is included in which of the following paragraphs of the audit report? **(Page 15)**

   "We conducted our audit in accordance with auditing standards generally accepted in the United States of America."

   a. Introductory. [This answer is incorrect. The introductory paragraph is the opening paragraph of the standard report and contains a statement that the financial statements identified in the report were audited.]

   b. Scope. [This answer is correct. The first sentence of the scope paragraph contains a statement that the audit was conducted in accordance with generally accepted standards and identifies the United State of America as the country of origin of those standards. This guidance comes from SAS No. 58.]

   c. Opinion. [This answer is incorrect. The purpose of the opinion paragraph is to simply express an opinion on whether financial statements *are presented fairly in conformity with GAAS*.]

   d. Conclusion. [This answer is incorrect. Following the opinion paragraph is the firm's signature. It is not necessary to include a conclusion paragraph in the standard report.]

6. The degree of responsibility the auditor is taking and the character of the auditor's work is listed under which of the following GAAS headings? **(Page 15)**

   a. General standards. [This answer is incorrect. The general standards deal with the qualifications of personnel assigned to an audit and the professional care expected.]

   b. Standards of field work. [This answer is incorrect. The standards of field work deal with the nature and adequacy of the work performed during the audit, including the confirmation of receivables and observation of inventories.]

   c. Standards of reporting. [This answer is correct. The standards of reporting under GAAS deal with matters relating to the opinion expressed as a result of the audit. This would include the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.]

7. If Agnes Auditor is reporting on internal control over financial reporting, the scope of Agnes' procedures is considered greater under which of the following? **(Page 16)**

   a. GAAS. [This answer is incorrect. The procedures required by GAAS are intended to provide an auditor with a sufficient understanding of internal control to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures to be performed.]

   b. ASB. [This answer is incorrect. Prior to the enactment of the Sarbanes-Oxley Act of 2002, generally accepted auditing standards in the U.S. consisted of a single body of authoritative literature issued by the AICPA's Auditing Standards Board (ASB). The ASB does not apply in this situation.]

   c. PCAOB. [This answer is correct. If Agnes reported under the PCAOB standards, the scope would be greater under the PCAOB standards. Under PCAOB standards, the auditors are required to perform procedures sufficient for them to express an opinion on the company's internal control over financial reporting.]

8. A statement declaring that the auditors believe the procedures applied provide a reasonable basis for the opinion presented is included at the end of which of the following paragraphs of the standard audit report? **(Page 17)**

    a. Introductory. [This answer is incorrect. The last paragraph of the introductory paragraph states that it is the auditor's responsibility to express an opinion on the financial statements based on the audit.]

    b. Scope. [This answer is correct. The scope paragraph closes with a statement that the auditors believe the procedures applied provide a reasonable basis for the opinion presented. In the context of the sentences preceding it, that statement informs users that even though an audit has certain inherent limitations, the auditors have formed a positive conclusion about the scope of the audit work performed.]

    c. Opinion paragraph. [This answer is incorrect. The last statement of the opinion paragraph deals with conformity of GAAS.]

9. Which of the following interpretations provides guidance on modifying the auditor's report when an audit of a nonpublic entity is performed in accordance with GAAS *and* the PCAOB auditing standards? **(Page 17)**

    a. Interpretation No. 14. [This answer is incorrect. Interpretation No. 14 indicates that auditors should consider disclosing other matters required by GAAP in OCBOA financial statements, such as contingent liabilities and going concern considerations.]

    b. Interpretation No. 17. [This answer is incorrect. Interpretation No. 17 provides guidance on including additional optional language in the scope paragraph of the auditor's report to clarify that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as an audit for the purpose of expressing an opinion on the effectiveness of internal control over financial reporting.]

    c. Interpretation No. 18. [This answer is correct. Interpretation No. 18 notes that if an auditor performs an audit of a nonissuer in accordance with PCAOB auditing standards, the report may indicate that the audit was performed in accordance with both the AICPA Auditing Standards Board's generally accepted auditing standards and PCAOB auditing standards.]

    d. Interpretation No. 32. [This answer is incorrect. Interpretation No. 32 clarifies the percentage limitations to be used in recognizing investment tax credit in the computation of income tax expense for financial reporting purposes.]

THE OPINION PARAGRAPH

The purpose of the opinion paragraph is to *express an opinion* on whether the financial statements *are presented fairly in conformity with generally accepted accounting principles*. This lesson discusses the "clean opinion" only.

Identification of the Financial Statements

The phrase "the financial statements referred to above" makes it clear that the statements covered by the opinion paragraph are those identified in the introductory paragraph. An alternative some auditors prefer is to repeat the statement titles that are referred to in the introductory paragraph. When that is done, the opinion paragraph would be worded as follows:

> In our opinion, the accompanying balance sheet and statements of income, retained earnings, and cash flows present fairly, in all material respects, the financial position of , , ,

Some auditors substitute the phrase "the accompanying financial statements" for the phrase "the financial statements referred to above." That phrase also is acceptable but should be used with caution, especially if additional information or other information is included in the report package.

Present Fairly

The opinion paragraph of the standard report should state whether the financial statements are presented fairly, in all material respects, in accordance with generally accepted accounting principles. SAS No. 69 at AU 411.04 states that auditors make that judgment after considering whether:

a. the accounting principles selected and applied have general acceptance,

b. the accounting principles are appropriate in the circumstances,

c. the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation,

d. the information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed, and

e. the financial statements reflect the underlying events and transactions in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.

The SAS makes clear that fair presentation is not a separate standard. It always must be related to the basis of presentation, either GAAP or an OCBOA. A draft of a final Statement on Auditing Standards that will delete the GAAP hierarchy for nongovernmental entities from SAS No. 69 explicitly states that concept in paragraph 3 as follows:

> The independent auditor's judgment concerning the "fairness" of the overall presentation of financial statements should be applied within the framework of generally accepted accounting principles. Without that framework, the auditor would have no uniform standard for judging the presentation of financial position, results of operations, and cash flows in financial statements.

In All Material Respects

The phrase "in all material respects" is intended to inform users that the auditors' opinion does not attest to the absolute accuracy of the financial statements.

Financial Position

In the opinion paragraph, the auditors state whether the financial statements present fairly the "financial position . . . and the results of operations and cash flows . . ." Financial position refers to the resources and obligations of a company at a point in time, e.g., as of or at December 31, 20X1. Financial position of a company is communicated by the balance sheet, which occasionally is referred to as the "statement of financial position." For a balance sheet to present fairly the financial position of a company in conformity with GAAP, it must present three basic categories: (a) assets, (b) liabilities, and (c) owners' equity.

Occasionally, in certain industries such as banks, mutual funds, and similar financial enterprises, the title "statement of financial condition" is substituted for "balance sheet" in the introductory paragraph, and "financial condition" is substituted for "financial position" in the opinion paragraph.

Results of Operations

The above paragraph points out that financial position refers to a measurement at a point in time. That contrasts with the results of operations, which is a measurement over a period of time, i.e., for the year or other period. For the financial statements to present fairly results of operations, they generally contain both a statement of income and a statement of retained earnings (presented separately or combined).

Accountants may question how detailed a statement of income must be to conform with GAAP. While authoritative literature discusses the presentation of certain items, such as extraordinary items, discontinued operations, and income taxes, there is no specific guidance on how much detail must be shown for items such as sales, cost of sales, or operating expenses. As a general rule, an abbreviated statement that starts with gross profit or operating income is not detailed enough. Also, a statement that only summarizes income for the period without compensating detail in notes would not be acceptable. As a general rule, the income statement should disclose, on the face of the statement or in the notes, significant elements of revenue, costs, and expenses for the period in addition to items required by GAAP, such as depreciation and interest expense.

While it is customary to reflect changes in retained earnings on the face of the statement of income or in a separate statement of retained earnings or stockholders' equity, it also is acceptable to make that disclosure on the face of the balance sheet or in a note to the financial statements. Failure to disclose the changes in retained earnings is a departure from GAAP.

According to SAS No. 58 (AU 508.06), whether a statement of retained earnings or statement of changes in stockholders' equity is presented, it should be identified in the introductory paragraph but need not be reported on separately in the opinion paragraph. Changes in stockholders' equity are considered to be part of the presentation of financial position, results of operations, and cash flows.

FASB ASC 220 (formerly SFAS No. 130) requires a company to report comprehensive income either in a separate financial statement or in combination with an existing statement. Whether a separate statement of comprehensive income or a combined statement is presented, the financial statement titles identified in the introductory paragraph may require modification. However, comprehensive income does not need to be reported on separately in the opinion paragraph as it is considered to be part of results of operations.

Cash Flows

FASB ASC 230 (formerly SFAS No. 95) requires a statement of cash flows whenever financial statements purport to present both financial position (balance sheet) and results of operations (statement of income and retained earnings). If both financial position and results of operations are presented, FASB ASC 230 (formerly SFAS No. 95) requires a statement of cash flows for each period for which an income statement is presented.

Company Name

The company name is repeated in the opinion paragraph. However, it is not necessary to repeat any parenthetical disclosure of the type of entity or state of incorporation.

Dates

The date of the financial statements referred to in the opinion paragraph should be consistent with the dates indicated in the introductory paragraph.

Generally Accepted Accounting Principles

The first standard of reporting requires auditors who have audited financial statements in accordance with generally accepted auditing standards to state in their report whether the statements are presented in conformity with generally accepted accounting principles. SAS No. 58 at AU 508.08 also requires the report to include an identification that the United States of America is the country of origin of those accounting principles (for example, "accounting principles generally accepted in the United States of America" or "U.S. generally accepted accounting principles").

Consistency

The second standard of reporting is commonly referred to as the "consistency standard." The objective of the consistency standard is to identify the circumstances in which accounting principles have not been consistently observed. According to SAS No. 58 (AU 508), a reference to consistency in the auditor's report, through the addition of an explanatory paragraph following the opinion paragraph, is required only when accounting principles have *not* been consistently applied.

Auditors must consider whether accounting principles have been consistently applied in relation to the preceding period, regardless of whether financial statements of the preceding period are presented (SAS No. 1 at AU 420.22). The only situation in which auditors do not address consistency is a company's initial accounting period.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

10. Which of the following statements regarding the opinion paragraph is accurate?

    a. SAS No. 69 indicates that fair presentation of the financial statements is not a separate standard.

    b. The auditor uses the phrase "in all material respects" to inform users that his or her opinion attests to the absolute accuracy of the financial statements.

    c. Financial position refers to the measurement of resources and obligations of a company over a specified period of time.

    d. In many financial institutions, the title "financial condition" is substituted for "financial position" in the introductory paragraph.

11. Generally, the minimum detail required in a statement of income to be in conformity with GAAP is:

    a. An abbreviated statement that begins with gross profit or operating income.

    b. A statement that summarizes income for the period and omits compensating detail in notes.

    c. A statement that discloses significant elements of revenue, costs, and expenses for the period, including depreciation and interest expense.

12. Which of the following is the second standard of reporting?

    a. Identify the circumstances in which accounting principles have not been consistently observed.

    b. Requires auditors to state in their report if the statements are presented in conformity with GAAP.

    c. The auditor must sufficiently plan the work and properly supervise assistants.

    d. The audit must be performed by an auditor with technical training.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

10. Which of the following statements regarding the opinion paragraph is accurate? **(Page 22)**

    a. SAS No. 69 indicates that fair presentation of the financial statements is not a separate standard. [This answer is correct. SAS No. 69 makes it clear that fair presentation is not a separate standard and it always must be related to the basis of presentation, either GAAP or an OCBOA because without that framework, the auditor would have no uniform standard.]

    b. The auditor uses the phrase "in all material respects" to inform users that his or her opinion attests to the absolute accuracy of the financial statements. [This answer is incorrect. The auditor uses the phrase "in all material respects" to inform users that his or her opinion does *not* attest to the absolute accuracy of the financial statements because an auditor is not asked to attest to absolute accuracy.]

    c. Financial position refers to the measurement of resources and obligations of a company over a specified period of time. [This answer is incorrect. Financial position refers to the measurement of resources and obligations of a company at a specific point in time (i.e. a specific date).]

    d. In many financial institutions, the title "financial condition" is substituted for "financial position" in the introductory paragraph. [This answer is incorrect. In many financial institutions such as banks or mutual funds, the title "financial condition" is substituted for "financial position" in the *opinion* paragraph, not in the introductory paragraph.]

11. Generally, the minimum detail required in a statement of income to be in conformity with GAAP is: **(Page 23)**

    a. An abbreviated statement that begins with gross profit or operating income. [This answer is incorrect. Although no specific guidance exists on how much detail must be shown, normally an abbreviated statement that begins with gross profit or operating income is not detailed enough to be in conformity with GAAP.]

    b. A statement that summarizes income for the period and omits compensating detail in notes. [This answer is incorrect. APB Opinion No. 9, paragraph 7, requires the financial statements to contain a statement of income, however, a statement that only summarizes income for the period without compensating detail in notes would not be acceptable.]

    c. A statement that discloses significant elements of revenue, costs, and expenses for the period, including depreciation and interest expense. [This answer is correct. While authoritative literature gives no specific guidance on the amount of detail required, a general rule exists that the income statement should disclose, on the face of the statement or in the notes, significant elements of revenue, costs, and expenses for the period as well as items GAAP requires, such as depreciation and interest expense.]

12. Which of the following is the second standard of reporting? **(Page 24)**

    a. **Identify the circumstances in which accounting principles have not been consistently observed. [This answer is correct. The second standard of reporting is commonly referred to as the consistency standard. The objective of the consistency standard is to identify the circumstances in which accounting principles have not been consistently observed.]**

    b. Requires auditors to state in their report if the statements are presented in conformity with GAAP. [This answer is incorrect. The first standard of reporting requires auditors who have audited financial statements in accordance with generally accepted auditing standards to state in their report whether the statements are presented in conformity with generally accepted accounting principles.]

    c. The auditor must sufficiently plan the work and properly supervise assistants. [This answer is incorrect. One of the standards of field work is that the auditor must adequately plan the work and must properly supervise any assistants.]

    d. The audit must be performed by an auditor with technical training. [This answer is incorrect. One of the general standards of the opinion paragraph is that the audit must be performed by a person or persons having adequate technical training and proficiency as an auditor.]

FIRM'S SIGNATURE

Normally, when the auditor's report is typed on the firm's letterhead, the firm's signature is manually signed. However, a typed signature also is acceptable. When the auditor's report is printed on plain paper or included in a client-prepared annual report, some firms print "Certified Public Accountants" below their firm's signature. (Use of the CPA designation may be restricted by state regulations.)

Some firms, especially multilocation firms, identify the city and state of the office that issued the report below the signature.

THE DATE OF THE AUDITOR'S REPORT

The audit report date represents the date that the auditors have obtained sufficient appropriate audit evidence to support the opinion on the financial statements. Among other things, such evidence includes evidence that—

a. The audit work has been reviewed.

b. The financial statements, including disclosures, have been prepared.

c. Management has taken responsibility for the financial statements.

The auditor cannot simply use the date that the audit team left the field unless he or she has sufficient appropriate audit evidence at that date. Generally, the date of management's written representation letter coincides with the date of the auditor's report (SAS No. 85 at AU 333.09). A proposed Statement on Auditing Standards, *Omnibus—2006*, would, among other things, amend SAS No. 85 by requiring management representations to be made as of the date of the auditor's report.

Dual Dating

SAS No. 1 at AU 530.05 is the authoritative literature that discusses the effect of subsequent events on the auditor's report date. That paragraph (as amended by SAS No. 98) is reproduced below:

> The independent auditor has two methods available for dating the report when a subsequent event disclosed in the financial statements occurs after completion of fieldwork but before the issuance of the related financial statements. The auditor may use "dual dating," for example, "February 16, 20_____, except for Note _____, as to which the date is March 1, 20_____," or may date the report as of the later date. In the former instance, the responsibility for events occurring subsequent to the completion of fieldwork is limited to the specific event referred to in the note (or otherwise disclosed). In the latter instance, the independent auditor's responsibility for subsequent events extends to the date of the report and, accordingly, the procedures outlined in [SAS No. 1 at] AU section 560.12 generally should be extended to that date.

Before SAS No. 103 was effective, auditors in certain circumstances may have delayed the issuance of the financial statements when fieldwork had been completed except for the pending resolution of an auditing or accounting matter (such as obtaining sufficient audit evidence to support the treatment of an item in the financial statements) and then dual dated their audit report as of the date that the pending matter was resolved. Under SAS No. 103, however, dual dating generally is appropriate only when a subsequent event occurs after the date of the auditor's report but before the report release date.

After the date of the auditor's report but before the financial statements are issued, any material subsequent event of which auditors become aware usually requires them to either (a) update their report to the date of the subsequent event (in which case the auditors also would have to extend their subsequent events review procedures to the later date) or (b) dual date their report. Except in rare cases when the financial statements are adjusted for a subsequent event but the event is not disclosed, it is *not* permissible to retain the original report date and merely disclose the events as occurring subsequent to the date of the auditor's report (SAS No. 1 at AU 530.03).

If the auditors have already released their report and subsequently are asked to reissue it, the rules for dual dating change. In those circumstances, the following alternatives should be considered:

a. Absent the occurrence of a subsequent event, additional copies of the original report may be released with the *original report date*. Dual dating is *not* appropriate (SAS No. 1 at AU 530.06).

b. When predecessor auditors reissue their report on prior-period financial statements, the predecessors should use the date of their previous report to avoid any implication that they have examined records, transactions, or events after that date (SAS No. 58 at AU 508.71–.73). If the predecessor auditors revise their report or if the financial statements are restated, they should dual date their report [unless the situation in alternative (c) below occurs].

c. When auditors are asked to reissue their report on prior-period financial statements and they become aware of a subsequent event of the type that only requires disclosure (SAS No. 1 at AU 560.05 and 560.08), the event may be disclosed in a separate note to the financial statements captioned as follows:

   NOTE X—Event Subsequent to the Date of the Report of Independent Auditor (unaudited)

   In those circumstances, the auditor's report would carry the same date as the original report (SAS No. 1 at AU 530.08).

d. When financial statements are adjusted because of a subsequent event, either the date of the reissued report should be brought forward to the date of the event causing the adjustment, or the report should be dual dated as of the date of the subsequent event (SAS No. 1 at AU 530.03–.05).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. When auditors have already released their report and thereafter are asked to reissue it, which of the following circumstances generally would call for dual dating of the report?

    a. The original report is released without adjustment to financial statements because no subsequent event has occurred.

    b. When predecessor auditors reissue their report on prior-period financial statements.

    c. Financial statements are adjusted due to a subsequent event and the date of the reissued report is not brought forward to the date of the event causing the adjustment.

14. In regards to dual dating, when would an auditor use the following caption?

    NOTE X—Event Subsequent to the Date of the Report of Independent Auditor (unaudited)

    a. Absent the occurrence of a subsequent event.

    b. When financial statements are adjusted because of a subsequent event.

    c. When predecessor auditors reissue their report on prior-period financial statements.

    d. When auditors are asked to reissue their report on prior-period financial statements and they become aware of a subsequent event of the type that only require disclosure.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. When auditors have already released their report and thereafter are asked to reissue it, which of the following circumstances generally would call for dual dating of the report? **(Page 29)**

    a. The original report is released without adjustment to financial statements because no subsequent event has occurred. [This answer is incorrect. If a subsequent event does not occur after the auditor has released his or her report, additional copies of the original report may be released with the *original report date*.]

    b. When predecessor auditors reissue their report on prior-period financial statements. [This answer is incorrect. When predecessor auditors reissue their report on prior-period financial statements, the predecessors should use the date of their previous report to avoid any implication that they have examined records, transactions, or events after that date.]

    c. Financial statements are adjusted due to a subsequent event and the date of the reissued report is not brought forward to the date of the event causing the adjustment. [This answer is correct. When financial statements are adjusted because of a subsequent event, and the date of the reissued report is not brought forward to the date of the event causing the adjustment, the report should be dual dated as of the date of the subsequent event in accordance with the requirements of SAS No. 1 at AU 530.03–.05).]

14. In regards to dual dating, when would an auditor use the following caption? **(Page 29)**

    NOTE X—Event Subsequent to the Date of the Report of Independent Auditor (unaudited)

    a. Absent the occurrence of a subsequent event. [This answer is incorrect. Absent the occurrence of a subsequent event, additional copies of the original report may be released with the original report date.]

    b. When financial statements are adjusted because of a subsequent event. [This answer is incorrect. When financial statements are adjusted because of a subsequent event, either the date of the reissued report should be brought forward to the date of the event causing the adjustment, or the report should be dual dated as of the date of the subsequent event.]

    c. When predecessor auditors reissue their report on prior-period financial statements. [This answer is incorrect. When predecessor auditors reissue their report on prior-period financial statements, the predecessors should use the date of their previous report to avoid any implication that they have examined records, transactions, or events after that date.]

    d. When auditors are asked to reissue their report on prior-period financial statements and they become aware of a subsequent event of the type that only require disclosure. [This answer is correct. When auditors are asked to reissue their report on prior-period financial statements and they become aware of a subsequent event of the type that only require disclosure, the event may be disclosed in a separate note to the financial statements using the caption above. In these circumstances, the auditor's report would carry the same date as the original report.]

AUDITOR'S REPORTS ON FINANCIAL STATEMENTS FOR INTERIM PERIODS

Standard Report

Auditors may be engaged to audit financial statements at an interim date, i.e., a date other than the fiscal year end of the company. The standard report on financial statements for interim periods follows.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the accompanying balance sheet of ABC Company (a Texas corporation) as of March 31, 20X1,[a] and the related statements of income, retained earnings, and cash flows for the three months then ended.[b] These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of March 31, 20X1,[a] and the results of its operations and its cash flows for the three months then ended[b] in conformity with accounting principles generally accepted in the United States of America.

Notes:

[a] The preceding interim report illustration differs from the standard report in Exhibit 1-1 because the balance sheet date in the introductory and opinion paragraphs is the interim date.

[b] The preceding interim report illustration differs from the standard report in Exhibit 1-1 because the statements of income, retained earnings, and cash flows are no longer "for the year then ended" but instead for the period that ends at the interim date, e.g., "for *the three months* then ended."

Different Interim Accounting Principles

An AICPA auditing interpretation, AU 9420.11–.15, offers some guidance regarding consistency in audits of interim financial statements. That interpretation states that consistency is not affected when the accounting principles used in preparing the annual financial statements have been modified in the interim period statements in accordance with APB Opinion No. 28 (FASB ASC 270). Modifications permitted by APB Opinion No. 28 (FASB ASC 270) are related to a change in reporting requirements (i.e., presenting financial information for only part of a year rather than an entire year), and they are intended to enhance, not impair, comparability between data for an interim and annual period.

INITIAL ACCOUNTING PERIOD

The previous section on reporting on financial statements of interim periods should not be confused with reporting on initial accounting periods. In the former circumstance, the period covered by the financial statements was not the first year of a company's operations. In the latter circumstance, the auditors are reporting on the first year of operations, which may be for a 12-month or shorter period.

Standard Report

The auditor's standard report on the financial statements for an initial accounting period follows.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the accompanying balance sheet of ABC Company (a Texas corporation) as of December 31, 20X2, and the related statements of income, stockholders' equity, and cash flows for the period from inception (May 8, 20X2) to December 31, 20X2.[a] These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the initial period then ended[b] in conformity with accounting principles generally accepted in the United States of America.

Notes:

[a] The auditor's standard report for an initial accounting period differs from the standard report in Exhibit 1-1 because the introductory paragraph indicates that the statements of income, stockholders' equity, and cash flows are for the initial period, e.g., "for the period from inception (May 8, 20X2) to December 31, 20X2." The financial statements normally would include a statement of stockholders' equity rather than a statement of retained earnings, because, in the initial period, there would be changes in the other components of stockholders' equity as well, e.g., the initial issue of stock and any additional paid-in capital.

[b] The auditor's standard report for an initial accounting period differs from the standard report in Exhibit 1-1 because the opinion paragraph now uses the phrase "for the initial period then ended."

The auditor's report for an initial accounting period should not be confused with a report on the first audit of an established company. If auditors are able to extend auditing procedures sufficiently to the opening balance sheet of an established company, they should issue the auditor's standard report illustrated in Exhibit 1-1.

BALANCE SHEET ONLY

Auditors are not precluded from issuing an unqualified opinion on a balance sheet presented alone if their application of GAAS is not limited and the balance sheet fairly presents financial position in accordance with GAAP. In fact, SAS No. 58 at AU 508.33 specifically allows such limited reporting engagements.

Standard Report

The standard report on a balance sheet follows.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the accompanying balance sheet[a] of ABC Company (a Texas corporation) as of December 31, 20X1. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

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

In our opinion, the balance sheet referred to above[b] presents fairly, in all material respects, the financial position[c] of ABC Company as of December 31, 20X1, in conformity with accounting principles generally accepted in the United States of America.

Notes:

[a] The only financial statement identified in the introductory and scope paragraphs is the balance sheet.

[b] The title of the statement usually is repeated again in the opinion paragraph instead of saying "the financial statement referred to above."

[c] The auditor expresses an opinion only on financial position. No reference is made to results of operations or to cash flows.

Accountants may have audited and reported on a complete set of financial statements for the same period for which they are asked to issue a report on a balance sheet presented alone. That might occur, for example, when the client requests a report on only a balance sheet to give to vendors for credit purposes. In those circumstances, the report should not refer to the audit of related financial statements that are not being presented. The only information relevant to the readers of such a report concerns the audit of the balance sheet.

If the auditors attach some of the notes from the complete financial statements to the balance sheet, an AICPA Technical Practice Aid at TIS 9080.03 warns that the notes to the complete financial statements that do not pertain to the balance sheet should be omitted. In that case, however, certain income statement disclosures may be considered to pertain to the balance sheet. For example, if depreciable property is a significant portion of assets, the disclosures prescribed by paragraph 5 of APB Opinion No. 12 (depreciation expense for the period, balances of major classes of depreciable assets at the balance sheet date, accumulated depreciation, and a general description of the methods used in computing depreciation) may be necessary for a fair presentation of the balance sheet. In addition, information about pension plans (other than expense for the period) also should be disclosed.

Disclosing Net Income or Loss

When only a balance sheet is presented, some auditors consider it desirable to disclose a loss that is sustained in the period ending with the date of the balance sheet. (Such disclosure is not required.) However, if the amount of loss (or income) is disclosed in the equity section on the face of the balance sheet or in a note, the audit should be sufficient in scope to enable them to form an opinion on such loss (or net income) even though the opinion in the report is limited to the balance sheet. Normally, the auditors would be in a position to take that responsibility for such a disclosure if the prior-year balance sheet had been audited, because the current year's income (or loss) would be the difference between the two audited balance sheets. If the scope of the work is not sufficient to permit the expression of an opinion on net income (loss) in relation to the balance sheet taken as a whole, the auditor's report should include an appropriate disclaimer or exception.

STATEMENT OF INCOME ONLY

Several reporting subtleties are often overlooked in an engagement to audit only a statement of income. First, it seems difficult, in most circumstances, for auditors to appropriately apply GAAS to the audit of a statement of income without performing substantial auditing procedures on both the opening and closing balance sheets for the accounting period. Some argue that auditors could not express an unqualified opinion on the statement of income unless they had audited both balance sheets.

Even after resolving the question of whether to audit both balance sheets, auditors still must determine whether statements of retained earnings and cash flows must also be presented. Many accountants believe that to express an opinion on the results of a company's operations, a combined statement of income and retained earnings is required, at a minimum. A standard report on a statement of income and retained earnings follows.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the accompanying statement of income and retained earnings[a] of ABC Company (a Texas corporation) for the year ended December 31, 20X1.[b] This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

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

In our opinion, the statement of income and retained earnings referred to above[d] presents fairly, in all material respects, the results of the operations[e] of ABC Company for the year ended December 31, 20X1,[b] in conformity with accounting principles generally accepted in the United States of America.

Notes:

[a] Both a statement of income and retained earnings are necessary to fairly present results of operations in conformity with GAAP.

[b] The description of the period presented is "for the year ended" (or other period such as "for the six months ended June 30, 20XX") instead of "as of" or "at" a particular date.

[c] The scope paragraph only refers to the statement of income and retained earnings.

[d] The opinion paragraph normally repeats the title of the statement instead of stating "the financial statement referred to above."

[e] The auditor expresses an opinion only about the presentation of results of operations. No reference is made to financial position or to cash flows.

Note disclosures generally are necessary when an income statement is presented separately. No single authoritative pronouncement addresses the issue of the matters that should be disclosed, but best-practices indicate the following advice based on various sources of guidance.

- AU 411.04 *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles"* states that the financial statements, including related notes, should be "informative of matters that may affect their use, understanding, and interpretation." That principle also applies when only an income statement is presented. In determining disclosures that may be necessary, the auditors should read the income statement from the viewpoint of a business person with a basic knowledge of accounting and consider whether disclosures have been made that would affect that type of reader's use, understanding, and conclusions about the statement.

- A technical practice aid (TIS 9080.03) states that if a balance sheet is presented separately, only disclosures relevant to the balance sheet should be made. It is believed that likewise, if a stand-alone income statement is presented, only disclosures relevant to the income statement should be made. Thus, for example, interest rates related to interest expense in the income statement should be disclosed. It is not believed, however, that pledged assets, maturities, or sinking fund requirements related to long-term debt need to be disclosed in notes to a stand-alone income statement.

- APB Opinion No. 22 (FASB ASC 235-10-50-1), *Disclosure of Accounting Policies*, requires disclosure of accounting policies pertinent to a stand-alone basic financial statement. Paragraph 13 of APB Opinion No. 22 (FASB ASC 235-10-50-4) lists some common accounting policy disclosures. It is believed the following policies should be disclosed (assuming the stand-alone income statement includes transactions related to those matters):

  - Basis of consolidation
  - Depreciation methods
  - Amortization of intangibles
  - Inventory pricing
  - Recognition of profit on long-term construction-type contracts

- SAS No. 62, *Special Reports* (AU 623.09–.10), includes a discussion on evaluating the adequacy of disclosure in financial statements prepared in conformity with bases of accounting other than GAAP. Although the discussion relates to financial statements presented on a basis other than GAAP, generally the following disclosures also would be appropriate for a stand-alone income statement presented in conformity with GAAP:

  - Summary of significant accounting policies
  - Uncertainties
  - Related party transactions
  - Subsequent events
  - Restrictions on assets and owners' equity

  In addition, Interpretation No. 14 of SAS No. 62 at AU 9623.95 indicates that auditors should consider disclosing other matters required by GAAP in OCBOA financial statements, such as contingent liabilities and going concern considerations.

- SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (FASB ASC 275), requires the following disclosures. Generally the disclosures would be appropriate for a stand-alone income statement:

  - Nature of operations

- - Use of estimates
  - Certain significant estimates (when specified criteria are met)
  - Current vulnerability due to certain concentrations (when specified criteria are met)

Exhibit 1-2 lists some disclosures typically relevant to a stand-alone income statement. The list (not necessarily all-inclusive) is based on the preceding discussion.

Exhibit 1-2

Disclosures Relevant to a Stand-alone Income Statement[a]

- The nature of the company's operations
- Accounting policies:
  - Basis of consolidation
  - Revenue recognition method if other than the point of sale
  - Basis of valuing inventory and method of determining cost
  - Depreciation methods
  - Method of accounting for trade receivables and for estimating and charging off uncollectible accounts
  - Other important or unusual accounting policies
- Depreciation and amortization expense, including estimated aggregate amortization expense for intangibles for each of the five succeeding fiscal years
- Interest incurred, expensed, and capitalized
- Research and development costs
- Realized and unrealized gain or loss on marketable securities, basis for determining cost in computing gain, and the amount included in the income statement for a change in valuation allowance
- Lease expense, including minimum rentals, contingent rentals, and sublease income, and general description of lease arrangements (terms, renewal or purchase options, escalation clauses, and basis for determining contingent rentals)
- Pension or profit sharing provision and other information about pension plans required by FASB ASC 715 (formerly SFAS No. 87) (as amended)
- Postretirement benefits other than pensions as required by FASB ASC 715 (formerly SFAS No. 106) (as amended)
- Information about impaired long-lived assets and intangibles and impairment losses charged to income
- Disclosures about derivative instruments and hedging activities required by FASB ASC 815 (formerly SFAS No. 133) (as amended)
- Information about investments accounted for by the equity method
- Related party transactions

- Common control relationships that could result in operating results different from those that would have been obtained if the companies were autonomous, even if there have been no transactions between the companies
- Disclosures about income taxes required by FASB ASC 740 (formerly FASBI No. 48 and SFAS No. 109)
- Contingencies
- Use of estimates and certain significant estimates
- Current vulnerability due to certain concentrations
- Information about discontinued operations and any related gains or losses
- Nature and financial effects of material unusual or infrequent events or transactions not qualifying as extraordinary items
- Information about extraordinary gains or losses and applicable income taxes
- Accounting changes that affect the income statement:
  - Change in principle or estimate
  - Change in reporting entity
  - Adoption of new principle
  - Correction of error
- Subsequent events
- Going concern considerations
- Disclosures about comprehensive income required by FASB ASC 220 (formerly SFAS No. 130)

Note:

[a] This list is intended to indicate some of the more common matters about which disclosures may be necessary in a stand-alone income statement. It is not intended to be all-inclusive or to specify details of the disclosures. For a comprehensive detailed checklist covering those matters and other specialized or less common disclosures that may be relevant in specific circumstances, see *PPC's Guide to Audits of Small Businesses*, *PPC's Guide to Preparing Financial Statements*, or *PPC's Guide to Compilation and Review Engagements*. Call (800) 323-8724 or visit **ppc.thomson.com** for order information.

* * *

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. Which of the following sources states that only disclosures relevant to the balance sheet should be made if a balance sheet is presented separately?

    a. AU 411.04 *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles."*

    b. Technical Practice Aid (TIS 9080.03).

    c. APB Opinion No. 22, *Disclosure of Accounting Policies*.

    d. SAS No. 62, *Special Reports* (AU 623.09–.10).

16. Nature of operations and use of estimates are disclosures required by which of the following statements of position?

    a. SOP 92-6.

    b. SOP 75-4.

    c. SOP 94-6.

    d. SOP 99-2.

17. Which of the following disclosures relevant to a stand-alone income statement is required by SFAS No. 133?

    a. Pension or profit sharing provision and other information concerning pension plans.

    b. Postretirement benefits other than pensions.

    c. Disclosures about comprehensive income.

    d. Disclosures about derivative instruments.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. Which of the following sources states that only disclosures relevant to the balance sheet should be made if a balance sheet is presented separately? **(Page 37)**

    a. AU 411.04 *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles."* [This answer is incorrect. AU 411.04 states that the financial statements, including related notes, should be "informative of matters that may affect their use, understanding, and interpretation." That principle also applies when only an income statement is presented.]

    b. Technical Practice Aid (TIS 9080.03). [This answer is answer is correct. Technical Practice Aid (TIS 9080.03) states that if a balance sheet is presented separately, only disclosures relevant to the balance sheet should be made. This principle is applied to when only an income statement is presented. For example, interest rates related to interest expense in the income statement should be disclosed.]

    c. APB Opinion No. 22, *Disclosure of Accounting Policies*. [This answer is incorrect. APB Opinion No. 22 (*Disclosure of Accounting Policies*) requires disclosures of accounting policies pertinent to a stand-alone basic financial statement. Paragraph 13 of APB Opinion No. 22 lists some common accounting policy disclosures.]

    d. SAS No. 62, *Special Reports* (AU 623.09–.10). [This answer is incorrect. SAS No. 62, *Special Reports* includes a discussion on evaluating the adequacy of disclosure in financial statements prepared in conformity with bases of accounting other than GAAP.]

16. Nature of operations and use of estimates are disclosures required by which of the following statements of position? **(Page 37)**

    a. SOP 92-6. [This answer is incorrect. The objective of SOP 92-6 is to provide information to employees, sponsors, trustees, and other financial statement users that is essential in assessing a plan's present and future ability to pay benefits when due.]

    b. SOP 75-4. [This answer is incorrect. SOP 75-4, deals with presentation and disclosure of financial forecasts.]

    c. SOP 94-6. [This answer is correct. SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires the following disclosures: nature of operations, use of estimates, certain significant estimates, and current vulnerability due to certain concentrations.]

    d. SOP 99-2. [This answer is incorrect. SOP 99-2 specifies the accounting for and disclosure of 401(h) features of defined benefit pension plans, by both defined benefit pension plans and health and welfare benefit plans.]

17. Which of the following disclosures relevant to a stand-alone income statement is required by SFAS No. 133? **(Exhibit 1-2, Page 38)**

    a. Pension or profit sharing provision and other information concerning pension plans. [This answer is incorrect. Pension or profit sharing provision and other information concerning pension plans relevant to a stand-alone income statement are required by SFAS No. 87.]

    b. Postretirement benefits other than pensions. [This answer is incorrect. Postretirement benefits other than pensions relevant to a stand-alone income statement are required by SFAS No. 106.]

    c. Disclosures about comprehensive income. [This answer is incorrect. Disclosures about comprehensive income relevant to a stand-alone income statement are required by SFAS No. 130.]

    d. Disclosures about derivative instruments. [This answer is correct. Disclosures about derivative instruments and hedging activities relevant to a stand-alone income statement are required by SFAS No. 133.]

AUDITOR'S REPORT ON FINANCIAL STATEMENTS COVERING PERIODS LESS THAN 12 MONTHS (CHANGE IN FISCAL YEAR-END)

This lesson has discussed one situation in which an auditor might be requested to report on financial statements covering a period of time shorter than 12 months (i.e., the first year of a company's operations). Another situation in which an auditor might be asked to report on financial statements for a shorter period is when there has been a change in the entity's fiscal year. That might happen, for example, when a corporation has elected S corporation status and is required to change to a December 31 year end unless it can show that the fiscal year is its natural business year. In such circumstances, companies also typically change their fiscal year for financial reporting purposes. Thus, the financial statements of the year of the change would cover less than 12 months.

A technical practice aid at TIS 1800.03 indicates that, generally, the change should be disclosed in the current period financial statements to make the statements more meaningful. The TPA generally suggests that in disclosing the change in fiscal year, the notes to the statements should state whether the effect was to increase or decrease net income (for example, if as a result of seasonal differences, the company normally experiences losses during the months excluded). In addition, if the effect is measurable, (i.e., net income for the excluded months is known), that amount should be disclosed.

When comparative financial statements are presented, it is believed the short-year financial statements may be presented in comparative form with the financial statements of complete years as long as the change in fiscal year is adequately disclosed and the financial statements are appropriately captioned, such as illustrated below:

- ABC COMPANY
  BALANCE SHEETS
  December 31, 20X2 and June 30, 20X2

	December 31, 20X2	June 30, 20X2

- ABC COMPANY
  STATEMENTS OF INCOME
  Six months ended December 31, 20X2,
  And Year Ended June 30, 20X2

	Six Months Ended December 31, 20X2	Year Ended June 30, 20X2

Standard Report in Year of Change

The auditor's standard report on the financial statements in the year of the change would be similar to the report on an initial accounting period illustrated on page 35, except as follows:

a. The phrase "for the period from inception (May 8, 20X2) to December 31, 20X2" in the introductory paragraph would be replaced with "for the six-month period then ended."

b. The phrase "for the initial period" in the opinion paragraph would be replaced with "for the six-month period."

Standard Report When Prior-period Statements Are Presented in Comparative Form

When comparative financial statements are presented, however, the following report illustrates the appropriate form of report.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the accompanying balance sheets of ABC Company (a Texas corporation) as of December 31, 20X2 and June 30, 20X2, and the related statements of income, retained earnings, and cash flows for the six-month and twelve-month periods then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2 and June 30, 20X2, and the results of its operations and its cash flows for the six-month and twelve-month periods then ended in conformity with accounting principles generally accepted in the United States of America.

The relevant aspects of the preceding report differ from the standard report on comparative financial statements illustrated earlier in this course, as indicated below:

a. The introductory paragraph indicates that the statements of income, retained earnings, and cash flows are for the six-month period ended December 31, 20X2 (e.g., for the period since the company's period fiscal year end) and the twelve-month period ended June 30, 20X2.

b. The opinion paragraph now used the phrase "for the six-month and twelve-month periods ended."

It is believed an explanatory paragraph describing the change in fiscal year is not required in the auditor's report. However, if the auditors believe the financial statements do not adequately disclose the change in fiscal year, they should consider modifying their opinion.

AUDITOR'S REPORT ON FINANCIAL STATEMENTS COVERING PERIODS LONGER THAN 12 MONTHS

Auditors sometimes report on financial statements covering a period longer than 12 months. The period may or may not end on the company's fiscal year end, but the report wording would be the same in either case. A Technical Practice Aid (TIS 9160.07) states that the auditor's report, as well as the title of the financial statements, should clearly indicate the period covered. A report covering more than 12 months may relate to the initial audit of a new business. For example, a company may begin operations on November 1, 20X1, and have its first audit cover the period from November 1, 20X1, through December 31, 20X2, a period of 14 months. In that case, the report illustrated earlier in this course would be appropriate. If a company that is not a new business requests a report covering more than 12 months, the report for an interim period illustrated earlier in this course would be appropriate, except that the number of months indicated would be more than 12, rather than less.

COMMON AUDIT REPORT DEFICIENCIES

The AICPA Peer Review Board issues a *Peer Reviewers' Alert* each time the Board needs to communicate information regarding peer review Standards and guidance. (Alerts are sequentially numbered with the year of issue as the first two digits and the second two digits indicating the Alert number for that year.) In May 2006, the AICPA issued *Consolidation of Peer Reviewers' Alert* that contains all current, relevant information from the 1997 Annual Reviewers' Letter through Reviewers' Alert 06-01. The consolidated alert includes the following common deficiencies related to auditors' reports:

Minor Report Deficiencies

- Omission of phrases or the use of phrases not in conformity with the appropriate standards for the type of report issued.
- Isolated instances of reports incorrectly dated, issued without a date, or without appropriate reference to all time periods covered by the financial statements.
- Isolated instances in which reports reflected financial statement titles and terminology not in accordance with professional standards.
- Financial statements prepared on a basis of accounting other than generally accepted accounting principles (OCBOA) that were properly reported on but contained inconsistencies between the report and the financial statements.
- Financial statement titles that were inconsistent with the report.

Significant Report Deficiencies

- Issuance of an audit report when the auditor is not independent.
- Auditor's report did not cover all periods presented by the financial statements.
- Failure to disclose an omission of the statement of cash flows in financial statements prepared in accordance with GAAP.
- Omission of the statement of income and retained earnings when referred to in the audit report.
- Failure to appropriately qualify an auditor's report for a scope limitation or departure from the basis of accounting used for the financial statements.
- Failure to disclose in the auditor's report a material departure from professional standards, such as omission of significant income tax provision on interim financial statements.
- Departures from the standard report wording such that the audit report does not contain the critical elements of applicable standards.
- Inappropriate references to GAAP in the auditor's report on financial statements in conformity with an OCBOA.

The consolidated alert also includes report deficiencies unique to entities in specialized industries and deficiencies related to financial statement presentation, auditor's procedures, audit documentation, and functional areas, such as personnel management and monitoring.

REPORTING CHECKLISTS

Reporting Guidance Checklist

There are an almost endless variety of situations that may affect the form or content of the auditor's report.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

18. Which of the following is considered a *minor* audit report deficiency?

    a. Departures from the standard report wording resulting in critical elements of applicable standards being omitted from the audit report.

    b. Failure to appropriately qualify an auditor's report for a departure from the basis of accounting used for the financial statements.

    c. Leaving out phrases that are not in conformity with the appropriate standards for the type of report issued.

    d. Leaving out the statement of income and retained earnings when referred to in the audit report.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

18. Which of the following is considered a *minor* audit report deficiency? **(Page 44)**

   a. Departures from the standard report wording resulting in critical elements of applicable standards being omitted from the audit report. [This answer is incorrect. Per the 1997 Annual Reviewers' Letter, departures from the standard report wording that prevents the audit report from containing the critical elements of applicable standards are considered *significant* audit report deficiencies.]

   b. Failure to appropriately qualify an auditor's report for a departure from the basis of accounting used for the financial statements. [This answer is incorrect. According to the 1997 Annual Reviewers' Letter, failure to appropriately qualify an auditor's report for either a scope limitation or a departure from the basis of accounting used for the financial statements is considered a *significant* audit report deficiency.]

   c. Leaving out phrases that are not in conformity with the appropriate standards for the type of report issued. [This answer is correct. Leaving out phrases or the use of phrases that are not in conformity with the appropriate standards for the type of report issued is considered a *minor* audit report deficiency per the 1997 Annual Reviewers' Letter through Reviewer's Alert 06-01 which includes the common deficiencies related to auditor's reports.]

   d. Leaving out the statement of income and retained earnings when referred to in the audit report. [This answer is incorrect. Omission of the statement of income and retained earnings when referred to in the audit report is considered a *significant* audit report deficiency per the 1997 Annual Reviewers' Letter through Reviewer's Alert 06-01.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (GARTG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following words should be included in the title of an auditor's report as required by SAS No. 58?

   a. Comprehensive.

   b. Independent.

   c. Standard.

   d. Materiality.

2. Emmitt is performing an audit of the Paradise Cowboy's Organization. While preparing the opinion paragraph of the standard report, Emmitt left out a critical part of the paragraph. Which of the following did Emmitt leave out of the opinion paragraph?

   In my opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Paradise Cowboy's Organization, and the results of its operations and its cash flows for the year ended in conformity with accounting principles generally accepted in the United States of America.

   a. Description of the audit process.

   b. Date.

   c. Type of entity.

   d. Statement about reasonable assurance.

3. An auditor engaged to audit the financial statements of an entity that is not a client should address the report to which of the following?

   a. The board of directors.

   b. The client.

   c. A third party.

   d. The entity's stockholders.

4. Which of the following statements about a reference to the auditor's report in the financial statements is true?

   a. Any reference to the auditor's report should imply that the financial statements are the auditor's representations.

   b. Like compiled or reviewed financial statements, audited financial statements are required to refer to the auditor's report.

   c. A reference such as "See accompanying notes and auditor's report," although not required, would be acceptable.

   d. The independent auditor's opinion is an integral part of the financial statements.

5. Which of the following is **not** a required part of the basic financial statements on which an auditor reports?

   a. Descriptions of accounting policies.

   b. Schedules.

   c. Explanatory material identified as being a part of the basic financial statement.

   d. Type of entity.

6. The introductory paragraph of a standard report includes three elements. Of the following, which three elements are included in the introductory paragraph?

i. A statement that the financial statements identified in the report were audited.

ii. A statement about reasonable insurance.

iii. Generally accepted accounting principles.

iv. A statement that the financial statements are the responsibility of management.

v. A statement of the auditor's responsibility.

   a. i, ii, v.

   b. ii, iv, v.

   c. i, iv, v.

   d. ii, iii, iv.

7. Nick prepared the following introductory paragraph for his auditor's report on the ABC Company, Inc.. Which of the following word (s) is being used incorrectly in the report?

   We have examined the accompanying balance sheet of ABC Company, Inc. as of December 31, 2006, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

   a. Opinion.

   b. Balance sheet.

   c. Responsibility.

   d. Examined.

8. Which of the following is one of the GAAS standards of field work?

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

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

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

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

9. The following statement best explains the purpose of the first sentence of which of the following paragraphs of the standard report.

   The auditors have complied with the standards established by the auditing profession for the performance of the audit.

   a. Introductory.

   b. Opinion.

   c. Scope.

   d. Description.

10. Ruth is performing an audit of PetSophistications, Inc. Ruth must assess the appropriateness of the accounting principles used by management. This step of the audit is described under which of the following paragraphs of the audit report?

    a. Scope.

    b. Opinion.

    c. Introductory.

    d. Description.

11. Which of the following paragraphs of the audit report provides reasonable assurance that financial statements are free of material misstatement?

    a. Opinion.

    b. Scope.

    c. Description.

    d. Introductory.

12. Departures from GAAS are commonly referred to as which of the following?

    a. Inherent limitations.

    b. Performance limitations.

    c. Opinion limitations.

    d. Scope limitations.

13. When identifying the financial statements in an auditor's report, which of the following phrases can an auditor substitute for the phrase "the accompanying financial statements?"

    a. "the financial statements referred to above."

    b. "the enclosed financial statements."

    c. "financial statements are presented fairly in conformity with GAAP."

    d. "the financial statements presented in this audit report."

14. An auditor can make a judgment if the financial statements are presented fairly after making specific considerations. Which of the following is one of the five considerations?

    a. The accounting principles selected and applied have general acceptance.

    b. The inclusion of extraordinary items.

    c. The disclosure of operating expenses.

    d. The inclusion of disclosures to the financial statements.

15. According to SFAS No. 58, if a statement of retained earnings is presented, it should be identified in which of the following?

    a. Scope paragraph.

    b. Opinion paragraph.

    c. Introductory paragraph.

    d. Balance sheet.

16. Which of the following statements is most accurate regarding the date of an auditor's report?

    a. The audit report date represents the date that the auditors have obtained sufficient appropriate audit evidence to support the opinion on the financial statements.

    b. Generally, the date of the entity's fiscal year should also be the date of the auditor's report.

    c. The auditor's report should be dated the day the partner signs the opinion letter.

    d. The auditors can use the date that the audit team left the field.

17. Which of the following sources of audit guidance indicate that auditors should consider disclosing matters such as liabilities and going concern considerations?

    a. Interpretation No. 14.

    b. AU 9420.11–.15.

    c. Interpretation 18.

    d. AU 315.

18. Which of the following situations would an auditor be asked to report on financial statements for a shorter period?

    a. When an entity has to restate prior-period earning due to material misstatements.

    b. When there has been a change in the entity's tax year.

    c. When there has been a change in the entity's fiscal year.

    d. When an entity changes for LIFO to FIFO.

19. In May 2006, the AICPA issued Consolidation of Peer Reviewers' Alert that contains all current, relevant information from the 1997 Annual Reviewers' Letter through Reviewers' Alert 06-01. The consolidated alert includes some common minor and significant deficiencies related to auditors' reports. Which of the following lists of report deficiencies are considered significant?

  i. Issuance of an audit report when the auditor is not independent.
  ii. Auditor's report did not cover all periods presented by the financial statements.
  iii. Financial statement titles that were inconsistent with the report.
  iv. Inappropriate references to GAAP in the auditor's report on financial statements in conformity with OCBOA.
  v. Isolated instances in which reports reflected financial statement titles and terminology not in accordance with professional standards.
  vi. Financial statements prepared on a basis of accounting other than generally accepted principles (OCBOA) that were properly reported on but contained inconsistencies between the report and the financial statements.

    a. i, ii, iv.
    b. ii, iv, vi.
    c. i, iii, v.
    d. iv, v, vi.

Lesson 2: Reporting on Internal Control

INTRODUCTION

This lesson explains how to identify and evaluate control deficiencies, as well as how to communicate significant deficiencies in internal controls identified as part of the audit, and reports on the processing of transactions by service organizations.

Learning Objectives:

Completion of this lesson will enable you to:
- Recognize control deficiencies.
- Discuss significant deficiencies in internal control identified as part of the audit.

DEFINITIONS

The following definitions apply to auditors' assessment of controls:

- *Internal Control*—Internal control is a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations (AU 314.41). There are five components of internal control: control environment, risk assessment, control activities, information and communication systems, and monitoring.

- *Control Deficiency*—A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. The communication of control deficiencies that are not considered significant deficiencies can be either written or oral.

- *Control Environment*—The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure (AU 314.41).

- *Risk Assessment*—Risk assessment is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed (AU 314.41).

- *Control Activities*—Control activities are the policies and procedures that help ensure that management directives are carried out (AU 314.41).

- *Information and Communication Systems*—Information and communication systems support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities (AU 314.41).

- *Monitoring*—Monitoring is a process that assesses the quality of internal control performance over time (AU 314.41).

- *Material Weakness*—A deficiency, or a combination of deficiencies, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected (AU 325.06).

- *Significant Deficiency*—A control deficiency, or a combination of control deficiencies, that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. (AU 325.06).

- *Those Charged with Governance*—The person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting and disclosure process. For entities with a board of directors, this term encompasses the term "board of directors or audit committees" expressed elsewhere in Statements on Auditing Standards. (SAS No. 103 at AU 339.15, footnote 5.) In some smaller entities, management and those charged with governance may be the same people, for example, the owner in an owner-managed entity.
- *User Auditors*—The auditors who report on the financial statements of the client (user) organization.
- *Client (User) Organization*—The entity that has engaged a service organization and whose financial statements are being audited.
- *Service Auditors*—The auditors who report on controls of a service organization that may be relevant to a user organization's internal control.
- *Service Organization*—The entity or segment of an entity that provides services to the client (user) organization.

IDENTIFYING AND EVALUATING CONTROL DEFICIENCIES

In an audit of financial statements, an auditor is not required to perform procedures to identify deficiencies in internal control. However, SAS No. 115 notes that during the course of an audit, an auditor may become aware of control deficiencies while obtaining an understanding of the entity's internal control, assessing the risks of material misstatement of the financial statements due to error or fraud, performing further audit procedures to respond to assessed risks, communicating with management or others, or otherwise. Accordingly, an auditor's awareness of control deficiencies varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed.

SAS No. 115 states that multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and, may, in combination, constitute a significant deficiency or material weakness, even though such deficiencies are individually insignificant. Thus, AU 325.13 requires auditors to evaluate control deficiencies individually and in the aggregate by significant account balance, disclosure, relevant assertion, and component of internal control to determine if the control deficiencies collectively result in significant deficiencies or material weaknesses.

SAS No. 115 requires auditors to evaluate the severity of each control deficiency identified during the audit to determine whether it is, individually or in combination, a significant deficiency or material weakness. According to SAS No. 115 (AU 325.08), the severity of an identified deficiency depends on (a) the magnitude of the potential misstatement resulting from the deficiency or deficiencies and (b) whether there is a reasonable possibility that the entity's controls will fail to prevent or detect and correct a misstatement of an account balance or disclosure. SAS No. 115 provides guidance on the factors affecting the magnitude of a potential misstatement and the factors affecting whether there is a reasonable possibility of a misstatement. In addition, if the auditor determines that a deficiency or combination of deficiencies is not a material weakness, SAS No. 115 requires auditors to consider "whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion"

According to SAS No. 115, the following are indicators of a material weakness:

a. Identification of fraud, whether or not material, on the part of senior management.

b. Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud.

c. The auditor's identification of a material misstatement in the financial statements for the period under audit in circumstances indicating that the misstatement would not have been detected by the entity's internal control.

d. Ineffective oversight of the entity's financial reporting and internal control by those charged with governance.

While SAS No. 115 identifies the factors noted above only as *indicators of material weakness,* the authors believe auditors generally would consider such deficiencies as material weaknesses unless there are compensating controls that mitigate the severity of the deficiency.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. "The policies and procedures that help ensure that management directives are carried out" is the definition for which of the following terms related to auditors' assessment of controls?

    a. Control activities.

    b. Control environment.

    c. Risk assessment.

    d. Internal control.

20. What is material weakness?

    a. A deficiency.

    b. A material misstatement.

    c. A control deficiency.

21. Which of the following statements regarding internal control deficiencies is most accurate?

    a. An auditor must perform procedures to identify deficiencies in internal control.

    b. An auditor's awareness of control deficiencies should be influenced only by the extent of audit procedures performed.

    c. Auditor's must evaluate control deficiencies individually.

22. Which control deficiency listed below ordinarily is at least a significant deficiency, but **not** necessarily a strong indicator of material weakness?

    a. Restatement of previously issued financial statements to indicate the correction of a material misstatement.

    b. Controls over the selection and application of accounting principles that are in conformity with GAAP.

    c. Ineffective oversight of the entity's financial reporting and internal control by those responsible for governance.

    d. Identification of any level of fraud by members of senior management.

23. Which of the following statements is accurate regarding control deficiencies?

    a. An auditor's awareness of control deficiencies is generally the same from audit to audit.

    b. An auditor's awareness of control deficiencies varies from audit to audit.

24. The example below best describes which of the following?

    J.T. is performing an audit of the Pittsburgh Ironworkers, Inc. J.T. found that the design of the operation does not allow management or employees to prevent misstatements on a timely basis.

    a. Control deficiency.

    b. Significant deficiency.

    c. Material weakness.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. "The policies and procedures that help ensure that management directives are carried out" is the definition for which of the following terms related to auditors' assessment of controls? **(Page 55)**

    a. Control activities. [This answer is correct. According to SAS No. 109, paragraph 41, control activities are the policies and procedures that help ensure that management directives are carried out.]

    b. Control environment. [This answer is incorrect. The control environment sets the tone of an organization, influencing the control consciousness of its people, is the foundation for all other components of internal control, and provides discipline and structure.]

    c. Risk assessment. [This answer is incorrect. Risk assessment is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.

    d. Internal control. [This answer is incorrect. Internal control is a process designed to provide reasonable assurance regarding the achievement of objectives in the areas of reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.]

20. What is material weakness? **(Page 55)**

    a. A deficiency. [This answer is correct. A material weakness is a deficiency, or a combination of deficiencies, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected per AU 314. 41.]

    b. A material misstatement. [This answer is incorrect. The definition for a material weakness mentions material misstatement, but in and of itself, material misstatement does not define material weakness.]

    c. A control deficiency. [This answer is incorrect. A significant deficiency is a control deficiency or a combination of control deficiencies that is less severe than a material weakness, yet important enough to merit attention by those charged with governance per AU 325.07.]

21. Which of the following statements regarding internal control deficiencies is most accurate? **(Page 56)**

    a. An auditor must perform procedures to identify deficiencies in internal control. [This answer is incorrect. In an audit of financial statements, an auditor is not required to perform procedures to identify deficiencies in internal control; however, SAS No. 115 notes that control deficiencies may be discovered while gaining an understanding of the entity's internal control.]

    b. An auditor's awareness of control deficiencies should be influenced only by the extent of audit procedures performed. [This answer is incorrect. An auditor's awareness of control deficiencies varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed.]

    c. Auditor's must evaluate control deficiencies individually. [This answer is correct. SAS No. 115 states that multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and, may, in combination, constitute a significant deficiency or material weakness, even though such deficiencies are individually insignificant. Thus, AU 325.13 requires auditors to evaluate control deficiencies individually and in the aggregate by significant account balance, disclosure, and component of internal control to determine if the control deficiencies collectively result in significant deficiencies or material weaknesses.]

22. Which control deficiency listed below ordinarily is at least a significant deficiency, but **not** necessarily a strong indicator of material weakness? **(Page 56)**

    a. Restatement of previously issued financial statements to indicate the correction of a material misstatement. [This answer is incorrect. This is an example of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of material weakness.]

    b. Controls over the selection and application of accounting principles that are in conformity with GAAP. [This answer is correct. Deficiency in the area of controls over the selection and application of accounting principles that are in conformity with GAAP is at least a significant deficiency, but generally not a strong indicator of material weakness.]

    c. Ineffective oversight of the entity's financial reporting and internal control by those responsible for governance. [This answer is incorrect. Ineffective oversight of the entity's financial reporting and internal control by those responsible for governance is a strong indicator of material weakness.]

    d. Identification of any level of fraud by members of senior management. [This answer is incorrect. One example of a deficiency that is a strong indicator of material weakness is the identification of fraud of any magnitude on the part of members of senior management.]

23. Which of the following statements is accurate regarding control deficiencies? **(Page 56)**

    a. An auditor's awareness of control deficiencies is generally the same from audit to audit. [This answer is incorrect. Because each audit is different, an auditor's awareness of control deficiencies will differ from one audit to the next.]

    b. An auditor's awareness of control deficiencies varies from audit to audit. [This answer is correct. An auditor's awareness of control deficiencies varies from audit to audit depending on the nature, timing, and extent of audit procedures performed.]

24. The example below best describes which of the following? **(Page 60)**

    J.T. is performing an audit of the Pittsburgh Ironworkers, Inc. J.T. found that the design of the operation does not allow management or employees to prevent misstatements on a timely basis.

    a. Control deficiency. [This answer is correct. A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.]

    b. Significant deficiency. [This answer is incorrect. A significant deficiency is a control deficiency, or a combination of control deficiencies, that is less severe than a material weakness yet important enough to merit attention by those charged with governance.]

    c. Material weakness. [This answer is incorrect. A material weakness is a deficiency, or a combination of entity's deficiencies, such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented or detected.]

COMMUNICATING SIGNIFICANT DEFICIENCIES IN INTERNAL CONTROL IDENTIFIED AS PART OF THE AUDIT

SAS No. 115 requires auditors to communicate significant deficiencies and material weaknesses identified in an audit to management and those charged with governance. The communication must be in writing and preferably must be made by the report release date, but should be made no later than 60 days following the report release date.

The communication should include significant deficiencies and material weaknesses previously communicated that have not yet been remedied, which may be communicated by referring to the auditors' previously issued written communication and the date of that communication.

Contents of the Written Communication

The auditor's written communication regarding significant deficiencies and material weaknesses identified during an audit of financial statements should include the following elements:

- A statement indicating the purpose of the auditor's consideration of internal control was to express an opinion on the financial statements, but not to express an opinion on the effectiveness of the entity's internal control.
- A statement indicating the auditor is not expressing an opinion on the effectiveness of internal control.
- A statement indicating that the auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.
- The definition of the term material weakness and, where relevant, the definition of the term significant deficiency.
- An identification of the matters that are considered to be significant deficiencies and those that are considered to be material weaknesses.
- A statement indicating that the communication is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be and should not be used by anyone other than those specified parties. (If an entity is required to furnish such auditor communications to a governmental authority, the auditors' communication may refer to them.)

The communication of significant deficiencies refers to an audit of financial statements. Although not explicitly required by SAS No. 115, it is generally recommended that if the auditor's report on the financial statements was qualified because of a scope restriction, the restriction and its effect on the consideration of internal control be indicated in the communication of significant deficiencies.

Illustrative Communication

The following is an example of a written communication in which the auditor *identified only* significant deficiencies during the audit. It also specifically states that there are no material weaknesses that were identified.

> To Management and the Board of Directors of ABC Company[a]
>
> In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20X1, in accordance with auditing standards generally accepted in the United States of America, we considered ABC Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.[b] Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.[c]

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and, therefore, there can be no assurance that all such deficiencies have been identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.[d] We did not identify any deficiencies in internal control that we consider to be material weaknesses.[e]

A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those changed with governance.[f] We consider the following deficiencies in ABC Company's internal control to be significant deficiencies:

[Describe the significant deficiencies identified during the audit.][h, i]

This communication is intended solely for the information and use of management, [identify the body or individuals charged with governance], and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.[j]

Firm's signature[k]

City, State
February 14, 20X2

Notes:

[a] The communication is addressed to management and those charged with governance. In most entities, governance is the collective responsibility of a board of directors, a supervisory board, partners, proprietors, a committee of management, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, such as the owner-manager where there are no other owners, or a sole trustee. In an owner-managed entity and other small entities, management and those charged with governance may be the same people.

[b] This sentence is the required statement that the purpose of the audit was to express an opinion on the financial statements, but not to express an opinion on the effectiveness of internal control over financial reporting. If the auditor's report on the financial statements was qualified because of a scope restriction, generally the restriction and its effect on the evaluation of internal control should be described in this communication.

[c] This sentence is the required statement that the auditor is not expressing an opinion on the effectiveness of internal control.

[d] This sentence defines "material weakness" as required by SAS No. 115.

[e] This sentence clarifies for users that no material weaknesses have been identified during the audit. While auditors are not required to communicate that none of the identified deficiencies were considered material weaknesses. However, many auditors elect to make this communication.

[f] Because it is relevant to this communication (that is, because the auditor identified and is communicating significant deficiencies), this sentence includes the definition of a significant deficiency.

[g] This sentence defines "significant deficiency" as required by SAS No. 115.

[h] Control deficiencies that auditors consider to be material weaknesses must be distinguished from those that are significant deficiencies and identified in the auditor's communication. Significant deficiencies that previously were communicated and have not yet been remediated should be repeated in the current year's communication. Such prior significant deficiencies may be communicated in writing by referring to the previously issued written communication and the date of that communication.

[i] Although not required, SAS No. 115 does not preclude auditors from also communicating matters that the auditor believes to be of potential benefit to the entity, such as recommendations for operational or administrative efficiency or for improving internal control, or matters that the entity has requested the auditor to communicate, such as control deficiencies that are not significant deficiencies or material weaknesses. Such matters may be communicated in this report or in a separate communication. (Such matters also may be communicated orally.) For example, a sentence such as the following could be added as the next to the last paragraph of the report:

> In addition, we noted other matters involving internal control and its operation that we have reported to management of ABC Company in a separate letter dated February 14, 20X2.

[j] This paragraph restricts the communication to management and those charged with governance. The communication also may refer to a governmental authority if that authority requires the company to furnish it a copy of the report. In that case, this paragraph might be worded as follows:

> This communication is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the organization, and [identify any specified governmental authorities] and is not intended to be and should not be used by anyone other than these specified parties.

[k] Preferably, the report should be dated the same as the release date of the auditor's report on the financial statements, but should be dated no later than 60 days following the report release date.

Other Matters That Might Be Included in the Report

Inherent Limitations of Internal Control. SAS No. 115 (AU 325.23), states that auditors may add a statement indicating the inherent limitations of internal control, including the possibility of management override of controls, to their report. SAS No. 115 does not provide sample language that can be used. In that case, they might add a sentence similar to the following as the second sentence of the second paragraph of the communication:

> In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected by such controls.

Nature and Extent of the Consideration of the Internal Control. SAS No. 115 (AU 325.23), states that auditors may wish to mention the specific extent and nature of their consideration of internal control during the audit. For example, if the auditors' consideration of internal control included procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented, but not procedures to test the operating effectiveness of controls, the auditors may wish to mention that in their communication of significant deficiencies to emphasize that their engagement was not directed to discovering significant deficiencies in internal control. In that case they might add the following sentence to their communication after the first sentence in the letter illustrated earlier.

> Our consideration of internal control included procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented, but it did not include procedures to test the operating effectiveness of controls, and accordingly, was not directed to discovering significant deficiencies in internal control.

Management Letter Comments. Auditors often add suggestions about deficiencies in control that are not serious enough to be considered significant deficiencies to their internal control reports. The comments may, alternatively, be reported separately or may be communicated orally. If the less serious deficiencies are reported in the same communication as the significant deficiencies, SAS No. 115 requires the communication to explicitly identify the comments that describe the significant deficiencies (i.e., identify the comments that refer to significant deficiencies and those that do not). Also, if the less serious deficiencies are reported in a separate communication, such as a management letter, although not required, some auditors choose to make reference to the other communication in their reports communicating significant deficiencies. In that case, a sentence such as the following could be added as the next to last paragraph of the report:

> In addition, we noted other matters involving the internal control and its operation that we have reported to management of ABC Company in a separate letter dated February 14, 20X2.

Use of the Report

SAS No. 115 requires that the communication on significant deficiencies indicate that it is intended for internal use, that is, use by management, those charged with governance, and others within the organization, and that it is not intended to be and should not be used by anyone other than these specified parties. SAS No. 115 also states that when governmental regulations require the report to be furnished to governmental authorities, it may refer to those authorities as well.

Recurring Items

SAS No. 115 (AU 325.17), requires significant deficiencies that were reported in previous years and have not yet been remediated to be repeated in the current year's communication. Such prior significant deficiencies may be communicated by referring to the auditor's previously issued written communication and the date of that communication. SAS No. 115 (AU 325.20), states:

> The existence of significant deficiencies or material weaknesses may already be known to management and may represent a conscious decision by management or those charged with governance to accept the of risk associated with the deficiencies because of cost or other considerations. Management is responsible for making decisions concerning costs to be incurred and related benefits. The auditor's responsibility to communicate significant deficiencies and material weaknesses exist regardless of management's decision.

If significant deficiencies identified in prior-year audits are repeated, generally there should be an indication that the same comments were made in prior communications. For convenience, such comments may be presented separately from new comments under a heading such as "Significant Deficiencies Communicated in Prior Years." Prior-year comments typically are presented after new comments, although some auditors present them first if they are more significant or numerous than the new comments.

Management's Response to the Auditor's Communication

Management may prepare (or may be required by a regulator to prepare) a written response to the auditor's SAS No. 115 communication, for example, describing the corrective action taken, plans to implement new controls, or a statement indicating that management believes the cost of correcting a significant deficiency or material weakness would exceed the benefits to be derived from doing so. If management's response is included in the same document containing the auditor's communication, the auditor should disclaim an opinion on the information by adding a paragraph such as the following to the auditor's communication:

> ABC Company's written response to the significant deficiencies [and material weaknesses] identified in our audit has not been subjected to the audit procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Reporting When There Are No Significant Deficiencies

SAS No. 115 (AU 325.25), precludes auditors from issuing a written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication (i.e., the fact that the auditors did not identify any significant deficiencies might lead readers to believe that there are none; but since the auditors do not have a responsibility to specifically identify significant deficiencies, they could have overlooked them). Therefore, in an audit engagement where no significant deficiencies or material weaknesses were identified, no SAS No. 115 communication would be provided to the client.

However, if there are no significant deficiencies or material weaknesses, less serious control deficiencies may still exist, and SAS No. 115 does not preclude auditors from communicating those to management. The form of communication is not subject to the requirements of SAS No. 115. Accordingly, auditors may want to include the deficiencies in a separate communication, such as a management letter.

Oral Reports

Auditors must communicate significant deficiencies and material weaknesses in internal control in writing. However, auditors may communicate less significant deficiencies or other matters they believe to be of potential benefit orally. In that case, SAS No. 115 (AU 325.21), requires auditors to document the communication.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

25. Below is an example of a statement that can be included in a report communicating significant deficiencies identified during an audit. Which of the following situations need to exist to include this statement in the report?

    In addition, we noted other matters involving the internal control and its operation that we have reported to management of ABC Company in a separate letter dated February 14, 20X2.

    a. Inherent limitations of internal control.

    b. Management letter comments.

    c. Nature and extent of the consideration of the internal control.

26. Which of the following statements regarding reporting when there are no significant deficiencies is most accurate?

    a. If no significant deficiencies are found, auditors must issue written communication stating that no deficiencies were found.

    b. According to SAS No. 112, if an auditor does not find any significant deficiencies, yet minor control deficiencies still exist, the auditor should issue written communication to management on the findings.

    c. Less significant deficiencies may be orally communicated to management.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

25. Below is an example of a statement that can be included in a report communicating significant deficiencies identified during an audit. Which of the following situations need to exist to include this statement in the report? **(Page 63)**

    In addition, we noted other matters involving the internal control and its operation that we have reported to management of ABC Company in a separate letter dated February 14, 20X2.

    a. Inherent limitations of internal control. [This answer is incorrect. According to SAS No. 115, auditors may add a statement indicating the inherent limitations of internal control, including the possibility of management override of controls, to their report. The statement above would not be an appropriate statement in this situation.]

    b. Management letter comments. [This answer is correct. If the less serious deficiencies are reported in a separate communication, such as a management letter, although not required, some auditors choose to make reference to the other communication in their reports communicating significant deficiencies. In that case, the statement above could be added as the next to last paragraph of the report.]

    c. Nature and extent of the consideration of the internal control. [This answer is incorrect. SAS No. 115, states that auditors may wish to mention the specific extent and nature of their consideration of internal control during the audit. When this situation exists, the above statement would not be appropriate.]

26. Which of the following statements regarding reporting when there are no significant deficiencies is most accurate? **(Page 64)**

    a. If no significant deficiencies are found, auditors must issue written communication stating that no deficiencies were found. [This answer is incorrect. SAS No. 115 (AU 325.21), precludes auditors from issuing a written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.]

    b. According to SAS No. 115, if an auditor does not find any significant deficiencies, yet minor control deficiencies still exist, the auditor should issue written communication to management on the findings. [This answer is incorrect. If there are no significant deficiencies, less serious control deficiencies may still exist, and SAS No. 115 does not preclude auditors from communicating those to management.]

    c. Less significant deficiencies may be orally communicated to management. [This answer is correct. Although auditors must communicate significant deficiencies and material weaknesses in internal control in writing, auditors may want to include less significant deficiencies orally. SAS No. 115 (AU 325.21 requires documentation.]

REPORTS ON THE PROCESSING OF TRANSACTIONS BY SERVICE ORGANIZATIONS

Authoritative Literature

SAS No. 70 (AU 324), *Service Organizations*, discusses factors to be considered in determining the significance of a service organization's controls to those of the user organization and gives guidance on determining whether information about a service organization's controls is necessary to plan an audit and for obtaining that information.

SAS No. 70 (AU 324) also does the following:

- Imposes a minimum six-month period of coverage for service auditor's reports expressing an opinion on a description of controls placed in operation and tests of operating effectiveness.

- Eliminates reports expressing an opinion on a system of internal accounting control of a segment of a service organization from the classification "service auditor's report." (Auditors would not be prohibited from issuing those reports; however, the applicable guidance would be included in the attest standards rather than in SAS No. 70.)

Specifically, SAS No. 70 (AU 324) provides guidance on the user auditor's consideration of the effect of the service organization on the internal control of the user organization and on the factors they should consider in using a service auditor's report, as well as guidance on the responsibilities of service auditors. *PPC's Guide to Nontraditional Engagements* contains detailed guidance and practice-aids for performing a SAS 70 engagement.

Proposed SAS and SSAE to Supersede SAS No. 70. In November 2008, the ASB issued two exposure drafts that would supersede SAS No. 70. One is an exposure draft of a Statement on Auditing Standards, *Audit Considerations Relating to an Entity Using A Service Organization,* that only contains guidance for user auditors; that is, auditors auditing the financial statements of entities that use a service organization. The other is an exposure draft of a Statement on Standards for Attestation Engagements, *Reporting on Controls at a Service Organization,* that would replace the guidance currently in SAS No. 70 for auditors reporting on controls at service organizations (i.e., service auditors). The comment period for both exposure drafts ended on February 17, 2009, and the ASB is expected to consider comment letters received and finalize the standards in the third quarter of 2009. As indicated in the exposure drafts, the effective date of the proposed SAS would not be earlier than for audits of financial statements for periods beginning on or after December 15, 2010. However, in the exposure draft of the proposed SSAE for service auditors, the ASB solicited comments about whether it would be feasible for the effective date to be concurrent with the effective date of an International Standard on Assurance Engagements (IASE) on the same topic, which might be earlier than December 15, 2010. It is expected that early implementation of both standards would be permitted.

The proposed SSAE has been drafted along the lines of AT 501 (discussed in section 1404) in that a service auditor would be able to accept an engagement to report on controls at a service organization only if management of the service organization provided the auditor with a written assertion about (a) the fairness of the presentation of the description of the service organization's system, (b) the suitability of the design of the controls to achieve the related control objectives stated in the description, and, in a type 2 engagement, (3) the operating effectiveness of those controls to achieve the related control objectives stated in the description. Furthermore, in a type 2 report, the service auditor's opinion on the fairness of the description of the service organization's system and on the suitability of the design of the controls would be for a period, rather than as of a specified date as is currently in SAS No. 70. The proposed SSAE also would modify the guidance currently in SAS No. 70 about the evidence the service auditor would be required to obtain when obtaining an understanding of the service organization's system and, in a type 2 engagement, assessing the operating effectiveness of controls.

Consideration of the Effect of a Service Organization on the Internal Control of the User Organization

When a user organization uses a service organization, transactions that affect the user organization's financial statements are subjected to controls that are, at least in part, physically and operationally separate from the user organization. An auditing Interpretation at AU 9324.04–.18 entitled "Service Organizations That Use the Services of

Other Service Organizations (Subservice Organizations)" provides guidance on how user auditors' and service auditors' procedures are affected if the service organization uses another service organization (for example, a bank trust department might use another service organization for its data processing). The auditing interpretation also addresses the impact on the service auditors' report if they use another service organization. Practice Alert 99-2, *How the Use of a Service Organization Affects Internal Control Considerations*, discusses factors auditors should consider when auditing the financial statements of entities that use service organizations. The Practice Alert, which is not authoritative, does not address the responsibilities of service auditors. The degree of interaction between the controls at the service organization and the user organization, as well as the nature and materiality of the transactions processed at the service organization, are the most important factors in determining the significance of the service organization's controls to the user organization's internal control. When the user auditors conclude that the service organization's controls are significant to the audit of the user organization, those controls are likely to affect the user auditors' understanding of internal control and control risk assessment for the user organization.

Understanding Sufficient to Assess the Risk of Material Misstatement and Design Further Audit Procedures. SAS No. 109 requires that auditors obtain an understanding of the client's internal control sufficient to assess the risk of material misstatement of the financial statements due to error or fraud and design the nature, timing, and extent of further audit procedures. Information about (a) the services provided by a service organization that are part of the user organization's information system and (b) the service organization's controls over those services may be obtained by reviewing sources such as the following:

- User manuals.
- System overviews.
- Technical manuals.
- The contract between the user organization and the service organization.
- Reports by service auditors, internal auditors, or regulatory authorities on the service organization's controls. Auditors should be alert to the fact that service auditors' engagements are being performed and reported on by personnel at consulting organizations that are not CPAs in public practice. User auditors should be aware that if a type 2 report is issued by anyone other than a CPA firm in the practice of public accounting, the user auditor should not rely on it for assurance that controls are working.
- Inquiring of or observing personnel at the client or at the service organization.

After considering the available information the user auditors may conclude that they have the means to obtain a sufficient understanding of the user organization's internal control to assess the risks of material misstatement. If not, the user auditors may consider contacting the service organization, through the user organization, to obtain specific information or to request that a service auditor be engaged to perform procedures to supply the necessary information; or, the user auditor may visit the service organization and perform such procedures. (Usually, the last alternative is the most costly to the user organization. For this reason, user auditors often rely on service auditors' reports on controls placed in operation for information to assist them in obtaining a sufficient understanding of the user organization's internal control.) If the user auditors are unable to obtain sufficient evidence to achieve their audit objectives, they should qualify their opinion or disclaim an opinion on the financial statements because of a scope limitation.

Control Risk Assessments. As a part of performing detailed audit planning, the auditor is required to assess the risk of material misstatement of the financial statements. That assessment includes an assessment of control risk for significant account balances and classes of transactions, including those that are affected by the activities of the service organization. In doing so, user auditors may identify controls that, if effective, would allow them to reduce the assessment of risk for particular assertions. If such controls are applied at the service organization, user auditors may obtain evidence to reduce the assessed level of control risk from one or more of the following:

a. Tests of the user organization's controls over the activities of the service organization (for example, user auditors may test the user organization's reconciliation of output reports with source documents).

b. A service auditor's report 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.

c. Appropriate tests of controls performed by the user auditor at the service organization.

Responsibilities of Service Auditors

SAS No. 70 (AU 324) states that service auditors should—

- Conduct the engagement in accordance with the general standards as well as with the applicable standards of fieldwork and reporting.
- Be independent from the service organization (although it is not necessary for the service auditor to be independent from every user organization).
- Determine (by discussions with appropriate levels of management at the service organization) that errors, fraud, and illegal acts that they become aware of have been communicated to affected user organizations, unless such matters are clearly inconsequential. (If management of the service organization has not communicated that information, the service auditor should inform the service organization's audit committee that such communication has not been made. If the audit committee refuses to take appropriate action, the service auditor should consider whether to resign from the engagement.)

The type of engagement to be performed and the related report to be prepared should be determined by the service organization. Sometimes, however, such decisions are best made after discussions with the user organizations to determine their needs. There are two types of reports that service auditors can issue:

a. *Report on Controls Placed in Operation (Referred to as a Type 1 Report)*—A service auditor's report on a service organization's description of the controls that may be relevant to a user organization's internal control, on whether such controls were suitably designed to achieve specific control objectives, and on whether they had been placed in operation as of a specific date.

b. *Report on Controls Placed in Operation and Tests of Operating Effectiveness (Referred to as a Type 2 Report)*—A service auditor's report on a service organization's description of the controls that may be relevant to a user organization's internal control, on whether such controls were suitably designed to achieve specific control objectives, on whether they had been placed in operation as of a specific date, and on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

Report on Controls Placed in Operation. A report on controls placed in operation may be helpful to user auditors in obtaining an understanding of the controls at the user organization. However, such a report does not provide evidence about the operating effectiveness of controls and thus does not provide a basis for the auditors to reduce their assessment of the risk of material misstatement.

A sample report on controls placed in operation at a service organization is presented below.

INDEPENDENT ACCOUNTANT'S REPORT

To XYZ Service Organization[a]

We have examined the accompanying description of controls related to the accounts receivable processing system[b] of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Organization's controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily, and (3) such controls had been placed in operation[c] as of December 31, 20X1.[d] The control objectives were specified by ABC

Company.[e] Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

We did not perform procedures to determine the operating effectiveness of controls for any period. Accordingly, we express no opinion on the operating effectiveness of any aspects of XYZ Service Organization's controls, individually or in the aggregate.[f]

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's controls that had been placed in operation as of December 31, 20X1. Also, in our opinion, the controls as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily.[g]

The description of the controls at XYZ Service Organization is as of December 31, 20X1, and any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.[h]

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers.[i]

Firm's signature

City, State
February 15, 20X2[j]

Notes:

[a] The report usually is addressed to the service organization or its board of directors.

[b] The service auditor's report should contain a specific reference to the applications, services, products, or other aspects of the service organization covered as described in the description accompanying the report. Such a description of controls and control objectives usually is prepared by the service organization. If it is prepared by the service auditor, the representations remain the responsibility of the service organization.

[c] The report should indicate the purpose of the service auditor's engagement, as well as the nature and scope of procedures performed. Specifically, the report should state that the purpose of the procedures was to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Organization's controls that may be relevant to a user organization's internal control, (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily, and (3) such controls had been placed in operation as of the date of the service auditor's engagement.

[d] Although the service auditor's report is as of a specified date, they should inquire about changes in the service organization's controls that may have occurred before the beginning of fieldwork. If the service auditors believe such changes would be significant to user organizations and their auditors, they should include those changes in the description of the service organization's controls.

[e] The report should identify the party who specified the control objectives. The control objectives may be specified by the service organization or by outside parties such as regulatory agencies, a

user group, or others. When they are not established by outside parties, the service auditor should be satisfied that they are reasonable in the circumstances and consistent with the service organization's contractual obligations.

[f] The report should disclaim an opinion on the operating effectiveness of the controls.

[g] The report should contain the service 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 specific date and whether, in the service auditor's opinion, the controls were suitably designed to provide reasonable assurance that the specified control objectives would have been achieved if those controls were complied with satisfactorily. This opinion, however, is not intended to provide evidence of operating effectiveness or to provide user auditors with a basis for concluding that control risk may be assessed below the maximum. (If the service auditors believe the description is inaccurate or insufficiently complete for user auditors, or if they believe that there are significant deficiencies in the design or operation of the service organization's controls, the report should so state and should contain sufficient detail to provide user auditors with an appropriate understanding.)

[h] The report should include a statement of the inherent limitations of the potential effectiveness of controls at the service organization and of the risk of projecting to future periods any evaluation of the description. An auditing interpretation at AU 9324.38–.40 indicates that service auditor's reports may be expanded to describe the risk of projecting to future periods any conclusions about the effectiveness of controls. Risk may result from changes to systems or controls or from failure to make needed changes. Accordingly, the last sentence of this paragraph may be expanded as follows:

> Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes made to the system or controls, or the failure to make needed changes to the system or controls, may alter the validity of such conclusions.

[i] The report should identify the parties for whom the report is intended. (It should not be distributed to potential customers.)

[j] The report should be dated as of the date of the completion of fieldwork.

Report on Controls Placed in Operation and Tests of Operating Effectiveness. A report on controls placed in operation and tests of operating effectiveness may be useful in providing user auditors with an understanding of the controls necessary to assess the risk of material misstatement as well as a basis for reducing their assessments of the risk of material misstatements.

A sample report on controls placed in operation and tests of operating effectiveness is presented below.

INDEPENDENT ACCOUNTANT'S REPORT

To XYZ Service Organization[a]

We have examined the accompanying description of controls related to the accounts receivable processing system[b] of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Service Organization's controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily, and (3) such controls had been placed in operation[c] as of December 31, 20X1.[d] The control objectives were specified by ABC Company.[e] Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's controls that had been placed in operation as of December 31, 20X1. Also, in our opinion, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily.[f]

In addition to the procedures we considered necessary to render our opinion as expressed in the previous paragraph, we applied tests to specific controls, listed in Schedule X,[g] to obtain evidence about their effectiveness in meeting the control objectives, described in Schedule X, during the period from July 1, 20X1 to December 31, 20X1.[h] The specific controls and the nature, timing, extent, and results of the tests are listed in Schedule X. This information has been provided to user organizations of XYZ Service Organization and to their auditors to be taken into consideration, along with information about the internal control at user organizations, when making assessments of control risk for user organizations. In our opinion, the controls that were tested, as described in Schedule X, were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives specified in Schedule X were achieved during the period from July 1, 20X1 to December 31, 20X1.[i] [However, the scope of our engagement did not include tests to determine whether control objectives not listed in Schedule X were achieved; accordingly, we express no opinion on the achievement of control objectives not included in Schedule X.][j]

The relative effectiveness and significance of specific controls at XYZ Service Organization and their effect on assessments of control risk at user organizations are dependent on their interaction with the controls and other factors present at individual user organizations.[k] We have performed no procedures to evaluate the effectiveness of controls at individual user organizations.[l]

The description of the controls at XYZ Service Organization is as of December 31, 20X1, and information about tests of the operating effectiveness of specified controls covers the period from July 1, 20X1 to December 31, 20X1. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the system in existence. The potential effectiveness of specified controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.[m]

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers.[n]

Firm's signature

City, State
February 15, 20X2[o]

Notes:

[a] The report usually is addressed to the service organization or its board of directors.

[b] The service auditor's report should contain a specific reference to the applications, services, products, or other aspects of the service organization covered as described in the description accompanying the report. Such a description of controls and control objectives usually is prepared by the service organization. If it is prepared by the service auditor, the representations remain the responsibility of the service organization.

[c] The report should indicate the purpose of the service auditor's engagement, as well as the nature and scope of procedures performed. Specifically, the report should state that the purpose of the procedures was to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Organization's controls that may be

relevant to a user organization's internal control, (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily, and (3) such controls had been placed in operation as of the date of the service auditor's engagement.

[d] The report should indicate the specified date as of which the service auditor determined that the controls had been placed in operation. Service auditors also should inquire about changes in the service organization's controls that may have occurred before the beginning of fieldwork. If the service auditors believe such changes would be significant to user organizations and their auditors, they should include those changes in the description of the service organization's controls.

[e] The report should identify the party who specified the control objectives. The control objectives may be specified by the service organization or by outside parties such as regulatory agencies, a user group, or others. When they are not established by outside parties, the service auditor should be satisfied that they are reasonable in the circumstances and consistent with the service organization's contractual obligations.

[f] The report should contain the service 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 specific date and whether, in the service auditor's opinion, the controls were suitably designed to provide reasonable assurance that the specified control objectives would be achieved if those controls were complied with satisfactorily. (If the service auditors believe the description is inaccurate or insufficiently complete for user auditors, or if they believe that there are significant deficiencies in the design or operation of the service organization's controls, the report should so state and should contain sufficient detail to provide user auditors with an appropriate understanding.)

[g] The report should include a reference to a description of tests of specified service organization controls designed to obtain evidence about the operating effectiveness of those controls in achieving specified control objectives. The description should include the controls that were tested, the control objectives the controls were intended to achieve, the tests applied, and the results of the tests. It also should include an indication of the nature, timing, and extent of tests, as well as sufficient detail to enable user auditors to determine the effect of such tests on user auditors' assessments of control risk. To the extent that service auditors identified causative factors for exceptions, determined the current status of corrective actions, or obtained other relevant qualitative information about exceptions noted, such information also should be provided. An interpretation titled *Describing Tests of Operating Effectiveness and the Results of Such Tests* at AU 9324.01–.03 provides additional guidance on the amount of detail that the report should include related to the description of the tests applied and the results of the tests.

[h] The report should include a statement of the period covered by the service auditor's report on the operating effectiveness of the specified controls. Note that this is different from the date identified in the first paragraph, which refers to the point in time as of which the controls had been placed in operation.

[i] The report should include the service auditor's opinion on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified. Results of specific tests of operating effectiveness may provide user auditors with evidence they may use to assess control risk below the maximum.

[j] When all of the control objectives listed in the description of controls placed in operation are not covered by tests of operating effectiveness, the report should include a statement that the service auditor does not express an opinion on control objectives not listed in the description of tests performed at the service organization.

[k] The report should include a statement that the relative effectiveness and significance of specific service organization controls and their effect on assessments of control risk at user organizations are dependent on their interaction with the controls and other factors present at individual user organizations.

[l] The report should include a statement that the service auditors have performed no procedures to evaluate the effectiveness of controls at individual user organizations.

[m] The report should contain a statement of the inherent limitations of the potential effectiveness of controls at the service organization and of the risk of projecting to future periods any evaluation of the description or any conclusions about the effectiveness of controls in achieving control objectives. An auditing interpretation at AU 9324.38–.40 indicates that service auditor's reports may be expanded to describe the risk of projecting to future periods any conclusions about the effectiveness of controls. Risk may result from changes to systems or controls or from failure to make needed changes. Accordingly, the last sentence of this paragraph may be expanded as follows:

> Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes made to the system or controls, or the failure to make needed changes to the system or controls, may alter the validity of such conclusions.

[n] The report should identify the parties for whom the report is intended. (It should not be distributed to potential customers.)

[o] The report should be dated as of the date of the completion of fieldwork.

If, in the service auditor's opinion, the service organization's description of controls is inaccurate or incomplete and does not provide user auditors with the information they need to plan their audits, the service auditor should modify the report on the service organization's description of controls. The following is an example of such an explanatory paragraph:

> The accompanying description states that ABC Service Organization uses operator identification numbers and passwords to prevent unauthorized access to the system. Based on inquiries of staff personnel and inspections of activities, we determined that such procedures are employed in Applications W and X but are not required to access the system in Applications Y and Z.

In addition, the first sentence of the opinion paragraph would be modified as follows:

> In our opinion, except for the matter referred to in the preceding paragraph, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's controls that had been placed in operation at December 31, 20X1.

If the service auditor determines that there are significant deficiencies in the design or operation of the service organization's controls, the service auditor should report those conditions in an explanatory paragraph placed before the opinion paragraph. The following is an example of such an explanatory paragraph:

> As discussed in the accompanying description, from time to time the Service Organization makes changes in application programs to correct deficiencies or to enhance capabilities. The procedures followed in determining whether to make changes, in designing the changes, and in implementing them do not include review and approval by authorized individuals who are independent from those involved in making the changes. There are also no specified requirements to test such changes or provide test results to an authorized reviewer prior to implementing the changes.

In addition, the second sentence of the opinion paragraph would be modified to read as follows:

> Also in our opinion, except for the deficiency referred to in the preceding paragraph, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily.

Report on Substantive Procedures. Service auditors may be requested to apply substantive procedures to user transactions or assets at service organizations. In such circumstances, service auditors may make specific reference to such procedures in their reports or issue a separate report in accordance with SSAE No. 10 (AT 201) *Agreed-Upon Procedures Engagements*.

Responsibility for Forward-looking Information. An auditing interpretation at AU 9324.35–.37 provides guidance on the auditor's responsibility to identify, in his or her report, deficiencies in the design of internal control that do not affect processing during the period covered by the report but may affect processing in future periods. The interpretation states that auditors do not have a responsibility to report such deficiencies. However, service auditors may choose to communicate the deficiencies to the service organization's management and advise them to disclose the information, as well as their plans for correcting the design deficiencies, in a section of the service auditor's document titled, "Other Information Provided by the Service Organization."

If the service organization provides such information, service auditors should read the information and consider the guidance in AU 550, *Other Information in Documents Containing Audited Financial Statements*. In addition, service auditors should disclaim an opinion on the information by adding the following paragraph to their report.

> The information in section X describing XYZ Service Organization's plans to modify its disaster recovery plan is presented by the Service Organization to provide additional information and is not a part of the Service Organization's description of controls that may be relevant to a user organization's internal control. Such information has not been subjected to the procedures applied in the examination of the description of the controls applicable to the processing of transactions for user organizations and, accordingly, we express no opinion on it.

Service auditors also may consider communicating information about the design deficiencies in a section of their document titled, "Other Information Provided by the Service Auditor."

Responsibility for Subsequent Events. Changes in a service organization's controls may occur subsequent to the period covered by the service auditor's report but before the date of the report. Those changes could affect user organizations' information systems. SAS No. 98, *Omnibus Statement on Auditing Standards—2002*, amends SAS No. 70 (AU 324) to address the responsibilities of service organizations and service auditors with respect to subsequent events. According to the amendment, service auditors have no responsibility to detect subsequent events. However, they should inquire about whether management is aware of subsequent events that would have a significant effect on user organizations and obtain a representation from management about subsequent events.

Service auditors should consider information that comes to their attention concerning (a) events that provide information about conditions that existed during the period covered by the service auditor's report and (b) events that provide information about conditions arising subsequent to the period covered by the service auditor's report that should be disclosed to prevent users from being misled. The information in (a) should be used by the service auditor in evaluating whether controls were placed in operation, suitably designed, and, if applicable, operating effectively during the period covered by the report. The information in (b) should be disclosed in a section of the service auditor's document titled, "Other Information Provided by the Service Organization." If the service organization does not disclose the information, the service auditor should disclose it in a section of the document titled, "Other Information Provided by the Service Auditor," and/or in the service auditor's report.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

27. Bill is an auditor auditing the financial statements of XYZ Company. He should refer to Practice Alert 99-2 if:

    a. He wants information on the responsibilities of service auditors.

    b. XYZ Company uses service organizations.

28. How is a report on controls helpful to user auditors?

    a. It helps the user auditor obtain an understanding of the controls at the user organization.

    b. It helps the user auditor perform procedures to determine the operating effectiveness of controls for any period.

    c. Provides evidence about the operating effectiveness of controls.

29. If, in the service auditor's opinion, the service organization's description of controls is inaccurate or incomplete and does not provide user auditors with the information they need to plan their audits, the service auditor should do which of the following?

    a. Report those conditions in an explanatory paragraph placed before the opinion paragraph.

    b. Make specific reference to substantive procedures in their reports.

    c. Modify the report on the service organization's description of controls.

    d. Read the information and consider the guidance in AU 550, *Other Information in Documents Containing Audited Financial Statements*.

30. Which of the following statements regarding an auditor's responsibility for subsequent events is most accurate?

    a. According to SAS No. 70, service auditors are responsible for detecting subsequent events.

    b. Service auditors should inquire about whether management is aware of subsequent events.

    c. Service auditors should consider information that comes to their attention concerning events that provide information about conditions that existed before the period covered by the service auditor's report.

    d. If the service organization does not disclose the information, the service auditor should disclose it in the first paragraph of the audit report.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

27. Bill is an auditor auditing the financial statements of XYZ Company. He should refer to Practice Alert 99-2 if: **(Page 67)**

    a. He wants information on the responsibilities of service auditors. [This answer is incorrect. Practice Alert 99-2 is not authoritative and does not address the responsibilities of service auditors.]

    b. XYZ Company uses service organizations. [This answer is correct. Practice Alert 99-2I, How the Use of a Service Organization Affects Internal Control Considerations, addresses factors auditors should consider when auditing the financial statements of entities that use service organizations.]

28. How is a report on controls helpful to user auditors? **(Page 69)**

    a. It helps the user auditor obtain an understanding of the controls at the user organization. [This answer is correct. A service auditor's report on a service organization's description of the controls that may be relevant to a user organization's internal control, on whether such controls were suitably designed to achieve specific control objectives, and on whether they had been placed in operation as of a specific date. This helps the user auditor obtain an understanding of the controls at the user organization.]

    b. It helps the user auditor perform procedures to determine the operating effectiveness of controls for any period. [This answer is incorrect. In the independent accounting report, the third paragraph states that no procedures were performed to determine procedures to determine the operating effectiveness of controls for any period. Accordingly, we express no opinion on the operating effectiveness of any aspects of XYZ Service Organization's controls, individually or in the aggregate.]

    c. Provides evidence about the operating effectiveness of controls. [This answer is incorrect. *Report on Controls Placed in Operation and Tests of Operating Effectiveness (Referred to as a Type 2 Report)* is a service auditor's report on a service organization's description of the controls that may be relevant to a user organization's internal control, on whether such controls were suitably designed to achieve specific control objectives, on whether they had been placed in operation as of a specific date, and on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.]

29. If, in the service auditor's opinion, the service organization's description of controls is inaccurate or incomplete and does not provide user auditors with the information they need to plan their audits, the service auditor should do which of the following? **(Page 74)**

    a. Report those conditions in an explanatory paragraph placed before the opinion paragraph. [This answer is incorrect. If the service auditor determines that there are significant deficiencies in the design or operation of the service organization's controls, the service auditor should report those conditions in an explanatory paragraph placed before the opinion paragraph.]

    b. Make specific reference to substantive procedures in their reports. [This answer is incorrect. Service auditors may be requested to apply substantive procedures to user transactions or assets at service organizations. In such circumstances, service auditors may make specific reference to such procedures in their reports or issue a separate report in accordance with SSAE No. 10 (AT 201) *Agreed-Upon Procedures Engagements*.]

    c. Modify the report on the service organization's description of controls. [This answer is correct. If, in the service auditor's opinion, the service organization's description of controls is inaccurate or incomplete and does not provide user auditors with the information they need to plan their audits, the service auditor should modify the report on the service organization's description of controls.

The following is an example of such an explanatory paragraph: The accompanying description states that ABC Service Organization uses operator identification numbers and passwords to prevent unauthorized access to the system. Based on inquiries of staff personnel and inspections of activities, we determined that such procedures are employed in Applications W and X but are not required to access the system in Applications Y and Z.]

d. Read the information and consider the guidance in AU 550, *Other Information in Documents Containing Audited Financial Statements*. [This answer is incorrect. If the service organization provides such information, service auditors should read the information and consider the guidance in AU 550, *Other Information in Documents Containing Audited Financial Statements*. In addition, service auditors should disclaim an opinion on the information by adding a paragraph to their report.]

30. Which of the following statements regarding an auditor's responsibility for subsequent events is most accurate? **(Page 75)**

a. According to SAS No. 70, service auditors are responsible for detecting subsequent events. [This answer is incorrect. According to SAS No. 98, service auditors have no responsibility to detect subsequent events.]

b. Service auditors should inquire about whether management is aware of subsequent events. [This answer is correct. According to SAS No. 98, auditors should inquire about whether management is aware of subsequent events that would have a significant effect on user organizations and obtain a representation from management about subsequent events.]

c. Service auditors should consider information that comes to their attention concerning events that provide information about conditions that existed before the period covered by the service auditor's report. [This answer is incorrect. Service auditors should consider information that comes to their attention concerning (a) events that provide information about conditions that existed during the period covered by the service auditor's report and (b) events that provide information about conditions arising subsequent to the period covered by the service auditor's report that should be disclosed to prevent users from being misled.]

d. If the service organization does not disclose the information, the service auditor should disclose it in the first paragraph of the audit report. [This answer is incorrect. If the service organization does not disclose the information, the service auditor should disclose it in a section of the document titled, "Other Information Provided by the Service Auditor," and/or in the service auditor's report.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (GARTG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

20. The process that assesses the quality of internal control performance over time is considered which of the following?

    a. Monitoring.

    b. Risk assessment.

    c. Control activities.

    d. Internal control over financial reporting.

21. Which of the following statements is true regarding an audit of financial statements?

    a. An auditor is required to perform procedures to identify deficiencies in internal control.

    b. An auditor is not required to perform procedures to identify deficiencies in internal control.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

22. Which of the following SASs requires auditors to evaluate the severity of each control deficiency to determine whether it is, individually or in combination, significant deficiency or material weakness?

    a. SAS No. 1.

    b. SAS No.15.

    c. SAS No.109.

    d. SAS No. 115.

23. J.T. is performing an audit of the Pittsburgh Ironworkers, Inc. J.T. must communicate any significant deficiencies in internal control identified in the audit within how may days following the report release date?

    a. 30.

    b. 60.

    c. 90.

    d. 120.

24. In the above example, how should J.T. communicate his findings?

    a. Verbally.

    b. In writing.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

25. The auditor's written communication regarding significant deficiencies in internal control identified during an audit should do all of the following **except:**

    a. Identify matters that are considered to be significant deficiencies.

    b. Include the definition of the term "internal control."

    c. Include the definition of the term "significant deficiency."

    d. State that the auditor is not expressing an opinion on the effectiveness of internal control.

26. According to the text, all of the following actions by auditors regarding suggestions about deficiencies in control that are not serious enough to be considered significant deficiencies are options to consider **except**:

    a. Suggestions may be added to their internal control reports.

    b. Auditors suggestions may be reported separately.

    c. Suggestions may be communicated orally by auditors.

    d. Suggestions about deficiencies not considered significant may be omitted.

27. The report on significant deficiencies is required by SAS No. 112 to indicate that it is **not** intended for use by which of the following?

    a. Those charged with governance.

    b. Designated persons outside the organization.

    c. Management personnel.

    d. Do not select this answer choice.

28. Which of the following periods of coverage is imposed by SAS No. 70 (AU 324), *Service Organizations,* for service auditor's reports that express an opinion on a description of controls placed in operation and tests of operating effectiveness?

    a. A minimum three-month period.

    b. A minimum four-month period.

    c. A minimum six-month period.

    d. A minimum nine-month period.

29. A user auditor may rely on which of the following report types, issued by someone other than a CPA firm in the practice of public accounting, for assurance that controls are working?

    a. Report on controls placed in operation (Type 1 Report).

    b. Report on controls placed in operation and tests of operating effectiveness (Type 2 Report).

    c. Do not select this answer choice.

    d. Do not select this answer choice.

30. True North Trust Department uses a third party to settle investment trades. The independent auditors for True North want some assurance on the internal controls of the third party processor. Upon which of the following audit guidelines may the independent auditors rely?

    a. SAS 70.

    b. SAS 103.

    c. SAS 109.

    d. SAS112.

GLOSSARY

Control activities: Control activities are the policies and procedures that help ensure that management directives are carried out.

Control deficiency: A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. The communication of control deficiencies that are not considered significant deficiencies can be either written or oral.

Control environment: The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

Information and communication systems: Information and communication systems support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

Internal control: Internal control is a process affected by those charged with governance, management, and other personnel:designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations (AU 314.41). There are five components of internal control: control environment, risk assessment, control activities, information and communication systems, and monitoring.

Internal control over financial reporting: The policies and procedures that pertain to an entity's ability to initiate, record, process, and report financial data consistent with the assertions embodied in either annual financial statements or interim financial statements, or both.

Introductory paragraph: The introductory (or opening) paragraph of the standard report includes three elements:

- A statement that the financial statements identified in the report were audited.
- A statement that the financial statements are the responsibility of management.
- A statement that the auditors' responsibility is limited to expressing an opinion on the financial statements based on the audit.

Material weakness: A deficiency, or a combination of deficiencies, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected on a timely basis.

Monitoring: A process that assesses the quality of internal control performance over time.

Opinion paragraph: The purpose of the opinion paragraph is to express an opinion on whether the financial statements *are presented fairly in conformity with generally accepted accounting principles*.

Risk assessment: The entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.

SAS No. 58: (AU 508) requires the auditor's report to be titled and the title to include the word independent to distinguish the report from representations of management (i.e., the financial statements) or internal auditors. It also requires the report to include an identification that the United States of America is the country of origin of those accounting principles (for example, "accounting principles generally accepted in the United States of America" or "U.S. generally accepted accounting principles").

SAS No. 62: Special Reports (AU 623.09—.10), includes a discussion on evaluating the adequacy of disclosure in financial statements prepared in conformity with bases of accounting other than GAAP.

SAS No. 95: States that auditors should be prepared to justify any departures from them. It also establishes the following three levels in the GAAS hierarchy:

- Auditing standards.
- Interpretive publications.
- Other auditing publications.

SAS No. 100 at AU 722: Requires auditors of a public company to communicate with management (and, in some cases, with the audit committee) as soon as practicable after they become aware of matters that cause them to believe that material modifications are required to be made to interim financial information for it to conform with GAAP or that the entity has filed the information with specified regulatory agencies prior to the completion of the review.

SAS No. 102: *Defining Professional Requirements in Statements on Auditing Standards*, defines certain terminology used in the audit standards.

SAS No. 103: Audit Documentation (AU section 339), requires auditors to adopt reasonable procedures to retain and access audit documentation for a period of time sufficient to meet the needs of their practice and to satisfy any applicable legal or regulatory requirements for records retention.

Scope paragraph: The first sentence of the scope paragraph contains a statement that the audit was conducted in accordance with generally accepted auditing standards and identifies the United States of America as the country of origin of those standards (for example, "auditing standards generally accepted in the United States of America" or "U.S. generally accepted auditing standards"). Simply stated, the auditors state that they complied with the standards established by the auditing profession for the performance of an audit.

Service auditors: The auditors who report on controls of a service organization that may be relevant to a user organization's internal control.

Service organization: The entity or segment of an entity that provides services to the client (user) organization.

Significant deficiency: A control deficiency, or a combination of control deficiencies, that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Those charged with governance: The person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting and disclosure process. For entities with a board of directors, this term encompasses the term "board of directors or audit committees" expressed elsewhere in Statements on Auditing Standards.

User auditors: The auditors who report on the financial statements of the client (user) organization.

User organization: The entity that has engaged a service organization and whose financial statements are being audited.

INDEX

COMPANION TO PPC'S GUIDE TO AUDITOR'S REPORTS

COURSE 2

GAAP Departures, Scope Limitations, Other Report Modifications, and Additional Information Accompanying the Basic Financial Statements (GARTG092)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course provides information regarding various aspects of the auditor's reports. Lesson 1 provides a detailed discussion of qualified opinions, adverse opinions, and disclaimers of opinion as well as the circumstances when each may be appropriate. Lesson 2 describes the circumstances that might preclude auditors from issuing an unqualified opinion on financial statements because of a limitation on the scope of the audit. Lesson 3 describes circumstances when auditors are either required to add or consider adding an explanatory paragraph to their report in various circumstances and illustrates how the auditors' report is to be modified in each situation. It also discusses emphasis-of-a-matter paragraphs and when they might be appropriate. Lesson 4 deals with additional information that should accompany basic financial statements.
PUBLICATION/REVISION DATE:	October 2009
RECOMMENDED FOR:	Users of *PPC's Guide to Auditor's Reports*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of auditing
CPE CREDIT:	8 QAS Hours, 8 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
FIELD OF STUDY:	Auditing
EXPIRATION DATE:	Postmark by **October 31, 2010**
KNOWLEDGE LEVEL:	Intermediate

Learning Objectives:

Lesson 1—Departures from Generally Accepted Accounting Principles (GAAP)

Completion of this lesson will enable you to:
- Define GAAP hierarchy and various GAAP measurement exceptions.
- Identify GAAP disclosure exceptions.

Lesson 2—Scope Limitations

Completion of this lesson will enable you to:
- Classify qualified opinions and disclaimers of opinion.
- Describe failure to confirm receivables or observe inventories.
- Define other scope limitations and when to withdraw from the engagement.

Lesson 3—Other Report Modifications

Completion of this lesson will enable you to:
- Summarize various aspects of emphasis-of-a-matter (EOM) paragraphs.
- Define modifications of the standard report including correction of an error, split-level reporting, and reports with more than one modification.
- Identify financial statements prepared in conformity with accounting principles generally accepted in another country.

Lesson 4—Additional Information Accompanying the Basic Financial Statements

Completion of this lesson will enable you to:
- Summarize additional information in auditor-submitted documents, modified reports, required supplementary information, and other information in client-prepared documents.
- Describe the auditor's responsibility regarding nonaccounting data and charts and graphs in auditor-submitted documents and when audited financial statements are included in client-prepared documents.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

> **Thomson Reuters**
> **Tax & Accounting—R&G**
> **GARTG092 Self-study CPE**
> **36786 Treasury Center**
> **Chicago, IL 60694-6700**

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Departures from Generally Accepted Accounting Principles (GAAP)

INTRODUCTION

Authoritative Literature

Auditors are required to qualify their report "except for" or, in certain circumstances, to express an adverse opinion, when the financial statements fail to present fairly financial position, results of operations, and cash flows because of (a) a measurement departure from generally accepted accounting principles or (b) inadequate disclosure of information required by generally accepted accounting principles.

Learning Objectives:

Completion of this lesson will enable you to:

- Define GAAP hierarchy and various GAAP measurement exceptions.
- Identify GAAP disclosure exceptions.

What Is GAAP?

In June 2009, the FASB issued FASB ASC 105-10 (formerly SFAS No. 168, *The Hierarchy of Generally Accepted Accounting Principles*) authorizes the *FASB Accounting Standards Codification*™ as the single source of authoritative generally accepted accounting principles to be applied by non-SEC companies. The authoritative version of the Codification, which was officially released on July 1, 2009, is effective for annual and interim periods ending after September 15, 2009. Accordingly, as of that date, there are only two levels of GAAP—authoritative and nonauthoritative. The *FASB Accounting Standards Codification* ™ includes all previously existing GAAP issued by standard-setters from more than 20 sources, including Accounting Principles Board Opinions, Accounting Research Bulletins, FASB Statements, FASB Staff Positions, FASB Interpretations, AICPA Interpretations, AICPA Statements of Positions, EITF Abstracts, AICPA Practice Bulletins, and AICPA Audit and Accounting Guides. Thus, the FASB Codification supersedes all of the previously existing GAAP guidance. The Codification can be accessed at the FASB website at **www.fasb.org**.

In deciding on the appropriate accounting treatment for transactions or events, SFAS No. 168 (FASB ASC 105-10-65-1) is explicit that if the accounting treatment is not specified by a pronouncement within a source of authoritative GAAP for that entity, companies should first follow:

- accounting principles for similar transactions and events within other authoritative GAAP in the FASB codifications, unless those accounting principles either prohibit the application of the accounting treatment to the specific transaction or event or indicate that it should not be applied by analogy, and then—

- nonauthoritative guidance from other sources.

Nonauthoritative guidance includes:

- Practices that are widely recognized and prevalent either generally or in the industry.

- FASB Concepts Statements.

- AICPA Issues Papers.

- International Financial Reporting Standards (IFRS) of the International Accounting Standards Board.

- Pronouncements of other professional associations or regulatory agencies.

- Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids.

- Accounting textbooks, handbooks, and articles.

Accountants may consider nonauthoritative guidance when the accounting for a transaction or event (or a similar transaction or event) is not addressed in the FASB Codification. In that case, the appropriateness of the nonauthoritative guidance depends on four things: (a) its relevance to the particular circumstances, (b) the specificity of the guidance, and (c) the general recognition of the issuer or the author as an authority and (d) the extent of use in practice. For example, generally FASB Concepts Statements would normally be the most influential source in the other accounting literature category.

Substance over Form. In some situations, a transaction may appear to be recorded in accordance with GAAP when, in reality, the substance of the transaction does not support the accounting treatment. Generally auditors should consider whether the substance of a transaction differs materially from its form.

Alternative Choices of GAAP. When criteria for selecting among alternative accounting principles have not been established by GAAP, auditors may conclude that more than one accounting principle is appropriate in the circumstances. There are few, if any, circumstances in which accountants may freely select from alternative sources of GAAP. For example, in selecting a method for pricing inventory, such as FIFO or LIFO, ARB No. 43 (FASB ASC 330-10-30-9) indicates that the major objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic income. Similarly, SFAS No. 154, *Accounting Changes and Error Corrections* (FASB ASC 250-10-45-19), states "an entity that concludes that the pattern of consumption of the expected benefits of an asset has changed, and determines that a new depreciation method better reflects that pattern, may be justified in making a change in accounting estimate effected by a change in accounting principle." Furthermore, even when more than one generally accepted accounting principle exists to account for specific transactions or events, companies should not make a change in accounting principles unless it can justify the use of an alternative accounting principle on the basis that the alternative principle is preferable.

Effective Date of FASB Codification. The FASB Codification is effective for annual and interim periods ending after September 15, 2009. Any change in accounting as a result of applying the Codification should be accounted for as a change in accounting principle or correction of an error, as appropriate.

Future Codification Updates. All new standards the FASB issues after it approves the codification will include two parts: the Accounting Standard background and basis for conclusions and the Codification Update Instructions. Codification updates will use a four-digit numbering scheme (for example, Codification Update 09-01), where the first two digits represent the year of the update and the last two digits represents the sequential number for the update. All authoritative GAAP issued by the FASB will apply this format, regardless of how such guidance was previously issued (for example, Statement of Financial Accounting Standard, FASB Staff Position, or EITF consensus).

The *FASB Accounting Standards Codification* ™ can be accessed at the FASB website at **www.fasb.org**.

GAAP MEASUREMENT EXCEPTIONS

Generally, a material measurement departure from GAAP is readily determinable. Many auditors refer to a GAAP checklist during their audit to ensure that they have considered appropriate GAAP for the particular circumstances.

Qualified Reports for GAAP Measurement Departures

When the financial statements are materially affected by a GAAP measurement departure and auditors have audited the statements in accordance with generally accepted auditing standards, they should express a qualified opinion or, if the departure is pervasive, an adverse opinion. A disclaimer of opinion *never* is an appropriate substitute when auditors have reached an affirmative conclusion that audited financial statements are not fairly presented in conformity with GAAP. An example of a qualified report follows.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the accompanying balance sheet of ABC Company (a Texas corporation) as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.[a]

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

The Company has excluded from property and debt in the accompanying balance sheet certain lease obligations that, in our opinion, should be included to conform with accounting principles generally accepted in the United States of America.[b] If those lease obligations were accounted for properly, property would be increased by $XXX, long-term debt by $XXX, current maturities of long-term debt by $XXX, and retained earnings by $XXX as of December 31, 20X1, and net income would be increased (decreased) by $XXX, for the year then ended.[c]

In our opinion, except for[d] the effects of not including certain lease obligations in property and debt, as discussed in the preceding paragraph, the financial statements referred to in the first paragraph[e] present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Notes:

[a] The introductory and scope paragraphs are the same as in the standard (unqualified) report. No limitations have been placed on the scope of the audit.

[b] An explanatory paragraph is added preceding the opinion paragraph to explain the substantive reasons for the qualification. Note that the first sentence clearly states the nature of the departure.

[c] SAS No. 58 at AU 508.38 requires the principal effects of the departure on financial position, results of operations, and cash flows to be disclosed if those effects are reasonably determinable. It also is permissible to explain the effect of the departure on the financial statements in a note to the financial statements, with the explanatory paragraph referring to the note. An example of an explanatory paragraph calling attention to additional information in a note to the financial statements is as follows:

> As more fully described in Note X to the financial statements, the Company has excluded the effects of certain lease obligations from property and debt in the accompanying balance sheet. In our opinion, accounting principles generally accepted in the United States of America require that such obligations be included in the balance sheet.

However, disclosing the effects of the departure on the financial statements in the auditor's report is preferred so the report can be regarded as freestanding.

The illustrative explanatory paragraph in SAS No. 58 at AU 508.39 also shows the effect of the departure on earnings per share. SFAS No. 128, *Earnings Per Share* (FASB ASC 260-10), requires public companies to report earnings per share, but there is no requirement for nonpublic companies to do so. Accordingly, in reporting on the financial statements of nonpublic companies, that disclosure is not needed.

[d] The "except for" qualification in the opinion paragraph immediately follows the phrase, "In our opinion, . . ." The opinion paragraph *should not begin*, "Except for . . . , in our opinion."

[e] It is considered preferable to specifically make reference to the "financial statements in the first paragraph" instead of using the phrase "the financial statements referred to above" to avoid confusion that the opinion relates only to the statements discussed in the explanatory paragraph.

Dollar Effect of a GAAP Departure Is Not Determinable

As previously discussed, SAS No. 58 at AU 508.38 indicates that the effects of a GAAP departure on financial position, results of operations, and cash flows must be disclosed "if practicable." According to footnote 15 at AU 508.38, "practicable" means that (a) "the information is reasonably obtainable from management's accounts and records" and (b) "providing the information in the report does not require the auditor to assume the position of a preparer of financial information." The footnote states that the information should be presented in the auditor's report (assuming it is not disclosed in the financial statements and referred to in the auditor's report) if it can be obtained from the client's records without a substantial increase in the normal amount of audit effort. SAS No. 58 also states that if the effects are not reasonably determinable, that fact should be stated in the explanatory paragraph. (The terms "practicable" and "reasonably determinable," as used in SAS No. 58, are considered to be synonymous.)

If the effects of GAAP departures are not reasonably determinable, the auditors should *not* conclude that the situation is a scope limitation that calls for a qualified opinion. A qualification or a disclaimer of opinion because of a scope limitation is appropriate when sufficient appropriate audit evidence 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.

When the effects of the departure cannot be reasonably determined, auditors must consider whether they may be material. A concern that the amount, if quantified, may be extremely material would normally lead auditors to issue an adverse opinion.

Adverse Opinions for GAAP Measurement Departures

An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, and cash flows of the company in conformity with GAAP. An adverse opinion is expressed when auditors conclude that the financial statements, taken as a whole, are not fairly presented because of the materiality of a GAAP departure.

Auditors seldom, if ever, issue an adverse opinion. When faced with that alternative, they have two courses of action:

a. Persuade the client to adjust the financial statements

b. Set forth the facts and express an adverse opinion

Normally alternative (a) may be achieved once the consequences of alternative (b) are explained to the client. If asked to withdraw, auditors should explain to the client their responsibility to communicate the facts surrounding the dismissal, when asked, to a successor auditor (as required by SAS No. 84 at AU 315). In addition, SAS No. 114 (AU 380.23–.25) requires auditors to communicate certain matters to those charged with governance, including significant findings from the audit and disagreements with management.

If the statements are not adjusted, auditors should set forth the facts concerning the departures from GAAP in an explanatory paragraph of their report. An example of an adverse opinion follows.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the accompanying balance sheet of ABC Company (a Texas corporation) as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.[a]

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

As discussed in Note 2 to the financial statements, on December 15, 20X1, judgment was entered against the Company in a lawsuit resulting in a liability to the Company of $XX,XXX. The liability has been excluded from the accompanying balance sheet. In our opinion, the liability should be recorded to conform with accounting principles generally accepted in the United States of America. If the liability were recorded, accounts payable would be increased by $XX,XXX, and retained earnings would be decreased by $XX,XXX as of December 31, 20X1, and net loss would be increased by $XX,XXX for the year then ended.[b]

In our opinion, because of the effects of the matter discussed in the preceding paragraph,[c] the financial statements referred to in the first paragraph do not present fairly,[d] in conformity with accounting principles generally accepted in the United States of America, the financial position of ABC Company as of December 31, 20X1, or the results of its operations or its cash flows for the year then ended.

Notes:

[a] The introductory and scope paragraphs are the same as in the standard (unqualified) report. No limitations have been placed on the scope of the audit.

[b] SAS No. 58 at AU 508.59 requires the principal effects of the departure on financial position, results of operations, and cash flows to be disclosed in the explanatory paragraph if those effects are reasonably determinable. If the effects of the departure are not reasonably determinable, the paragraph should so state.

[c] When an adverse opinion is expressed, the opinion paragraph should refer to a separate paragraph that discloses the reason for the adverse opinion.

[d] The opinion paragraph should specifically state that the "financial statements . . . do not present fairly . . . ." Note that in identifying the financial statements that are not fairly presented, it is recommended that the report refer to the financial statements identified in the first paragraph to avoid any confusion that the adverse opinion applies only to financial statements discussed in the explanatory paragraph.

SAS No. 58 at AU 508.16–.18 requires auditors to disclose material changes in accounting principles in an explanatory paragraph following the opinion paragraph of their report. SAS No. 58 does not specifically address, however, whether a lack of consistency should be described in a separate explanatory paragraph when auditors express an adverse opinion on the financial statements taken as a whole. Similarly, the SAS does not address whether the auditor's report should disclose any reservations about generally accepted accounting principles other than those giving rise to the adverse opinion. Generally auditors should disclose those matters in their report.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. SFAS No. 168, *The Hierarchy of Generally Accepted Accounting Principles,* was issued by the FASB. Which of the following occurred by the issuance of SFAS No. 168?

   a. The GAAP hierarchy for non-SEC companies was expanded to add additional levels of hierarchy.

   b. The GAAP hierarchy for non-SEC companies was replaced by two levels of GAAP.

2. ABC Company is a nongovernmental company that has an annual period ending on August 15, 2009. Which of the following authoritative sources of GAAP should ABC Company apply?

   a. The GAAP hierarchy in SFAS No. 162.

   b. The *FASB Accounting Standards Codification.*

3. In most cases, a material measurement departure:

   a. Generally is easy to determine.

   b. Generally is difficult to determine.

4. When auditors are faced with the possibility of having to issue an adverse opinion because the financial statements, taken as a whole, are not fairly presented because of the materiality of a GAAP departure, the auditors have two courses of action. Which of the following is **not** one of those options?

   a. Persuade the client to adjust the financial statements.

   b. Auditor can adjust the financial statements and issue a qualified opinion.

   c. Set forth the facts and express an adverse opinion.

5. Which of the following actions is required of auditors by SAS No. 58?

   a. Disclose material changes in accounting principles in an explanatory paragraph following the opinion paragraph of their report.

   b. Describe a lack of consistency in a separate explanatory paragraph when auditors express an adverse opinion on financial statements taken as a whole.

   c. Disclose reservations about generally accepted accounting principles in addition to those giving rise to the adverse opinion.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. SFAS No. 168, *The Hierarchy of Generally Accepted Accounting Principles,* was issued by the FASB. Which of the following occurred by the issuance of SFAS No. 168? **(Page 89)**

    a. The GAAP hierarchy for non-SEC companies was expanded to add additional levels of hierarchy. [This answer is incorrect. The *FASB Accounting Standards Codification* brings together all previously existing GAAP issued by more than 20 sources. Accordingly, there are now only two levels of GAAP, authoritative and nonauthoritative. The old levels of (a), (b), (c), and (d) are combined.]

    b. The GAAP hierarchy for non-SEC companies was replaced by two levels of GAAP. [This answer is correct. The FASB Accounting Standards Codification, authorized by SFAS No. 168, names only two levels of GAAP. Those two levels are authoritative and nonauthoritative. The FASB Codification supersedes all of the previously existing GAAP guidance.]

2. ABC Company is a nongovernmental company that has an annual period ending on August 15, 2009. Which of the following authoritative sources of GAAP should ABC Company apply? **(Page 89)**

    a. The GAAP hierarchy in SFAS No. 162. [This answer is correct. The GAAP hierarchy in SFAS No. 162 applies to nongovernmental companies whose annual and interim periods end by September 15, 2009. Since ABC Company's annual period ends by September 15, 2009 (August 15, 2009), the GAAP hierarchy in SFAS No. 162 applies.]

    b. The *FASB Accounting Standards Codification.* [This answer is incorrect. The FASB Accounting Standards Codification is effective for nongovernmental companies whose annual and interim periods end after September 15, 2009.]

3. In most cases, a material measurement departure: **(Page 90)**

    a. Generally is easy to determine. [This answer is correct. Generally, a material measurement departure from GAAP is readily determinable because auditors can use a GAAP checklist during their audit to ensure appropriate GAAP has been considered in each circumstance.]

    b. Generally is difficult to determine. [This answer is incorrect. Generally, a material measurement departure from GAAP is not difficult to determine by employing the sue of a GAAP checklist during the audit.]

4. When auditors conclude that the financial statements, taken as a whole, are not fairly presented because of the materiality of a GAAP departure, the auditors have two courses of action. Which of the following is **not** one of those options? **(Page 92)**

    a. Persuade the client to adjust the financial statements. [This answer is incorrect. The auditor can avoid having to issue an adverse opinion by persuading the client to adjust the financial statements to be in conformity with GAAP. SAS No. 114 requires auditors to communicate significant findings from the audit and disagreements with management. Communicating this to management might persuade the client to adjust the statements.]

    b. Auditor can adjust the financial statements and issue a qualified opinion. [This answer is correct. The auditor should never adjust the client's financial statements.]

    c. Set forth the facts and express an adverse opinion. [This answer is incorrect. The auditor can lay out the facts concerning the departure from GAAP in an explanatory paragraph in their report and express an adverse opinion but auditors seldom, if ever, issue an adverse opinion.]

5. Which of the following actions is required of auditors by SAS No. 58? **(Page 93)**

   a. Disclose material changes in accounting principles in an explanatory paragraph following the opinion paragraph of their report. [This answer is correct. Auditors are required by SAS No 58 at AU 508.16–.18 to disclose material changes in accounting principles in an explanatory paragraph following the opinion paragraph of their report.]

   b. Describe a lack of consistency in a separate explanatory paragraph when auditors express an adverse opinion on financial statements taken as a whole. [This answer is incorrect. SAS No. 58 does not specifically address whether a lack of consistency should be described in a separate explanatory paragraph when auditors express an adverse opinion on the financial statements taken as a whole. However, it is recommended that auditors disclose these matters in their report.]

   c. Disclose reservations about generally accepted accounting principles in addition to those giving rise to the adverse opinion. [This answer is incorrect. Although it is recommended, SAS No. 58 does not require auditors to disclose any reservations about generally accepted accounting principles other than those giving rise to the adverse opinion.]

GAAP DISCLOSURE EXCEPTIONS

General Requirement

The third standard of reporting, as discussed in SAS No. 32, *Adequacy of Disclosure in Financial Statements* at AU 431.01, states: "When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report." Guidelines used in considering the adequacy of disclosure include:

- Information essential for a fair presentation in conformity with GAAP should be set forth in the financial statements (of which the notes are an integral part). Such information relates to the form, arrangement, and content of the financial statements and notes.
- Verbosity should not be mistaken for adequate disclosure.
- Disclosure is not a substitute for a proper accounting measurement.
- Information disclosed in the notes should generally be limited to factual representations. If management's opinion about an event or transaction is disclosed and the auditors cannot determine the propriety of the representation, they should qualify their opinion on the financial statements.

SAS No. 32 at AU 431.03 and SAS No. 58 at AU 508.41 state that if the financial statements or accompanying notes omit information required by GAAP, auditors should express a qualified (except for) or an adverse opinion. In addition, auditors should include the omitted information in a separate paragraph of their report, *if practicable*. *Practicable*, means that the information is reasonably obtainable from management's accounts and records and that auditors are not required to assume the position of preparers to provide the information in their report.

Auditors rarely issue a qualified or adverse opinion because of inadequate disclosure. If the company objects to a disclosure, it, in turn, is disclosed in a separate paragraph of the auditors' report along with their exception in the opinion paragraph. However, there may be certain disclosure requirements that the company believes are not cost-beneficial to generate and, accordingly, auditors may issue a qualified opinion in those circumstances.

Qualified Reports for GAAP Disclosure Exceptions

An example of a report that is qualified for inadequate disclosure follows.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the accompanying balance sheet of ABC Company (a Texas corporation) as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.[a]

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

The Company's financial statements do not disclose the amount of future commitments under long-term operating leases. In our opinion, disclosure of that information is required to conform with accounting principles generally accepted in the United States of America; however, management believes it is impracticable to develop the information.[b]

In our opinion, except for the omission of the information discussed in the preceding paragraph,[c] the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Notes:

[a] The introductory and scope paragraphs are the same as in the standard (unqualified) report. No limitations have been placed on the scope of the audit.

[b] The explanatory paragraph discloses all of the information required by GAAP that has been omitted or, as in the illustration, explains the nature of the disclosure and that management considers it impracticable to develop the information.

[c] The qualification in the opinion paragraph differs slightly from the exception wording when there is a GAAP measurement departure because it does not refer to the effects of the departure on the financial statements.

Accountants commonly consult a GAAP disclosure checklist as a safeguard against omitting disclosures required by GAAP.

Adverse Opinions for GAAP Disclosure Exceptions

In rare situations, a GAAP disclosure omission may be so material that auditors will conclude an adverse opinion is appropriate. Such a report is illustrated in the following example.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the accompanying balance sheet of ABC Company (a Texas corporation) as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

The Company's financial statements do not disclose that on March 2, 20X2, subsequent to the date of the accompanying financial statements, the Company's production plant in Panama was seized by the Panamanian government. The asset balances in the accompanying balance sheet and the earnings and trend of earnings presented in the statement of income would have been materially affected if that event had occurred prior to December 31, 20X1. In our opinion, disclosure of that information is required to conform with accounting principles generally accepted in the United States of America. Management believes it is impracticable to determine the pro forma effects of that event on the December 31, 20X1, financial statements.

In our opinion, because of the omission of the information discussed in the preceding paragraph, the financial statements referred to in the first paragraph do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of

ABC Company as of December 31, 20X1, or the results of its operations or its cash flows for the year then ended.

Omission of a Statement of Cash Flows

If a company issues financial statements that purport to present financial position and results of operations but the statements omit the related statement of cash flows, auditors should issue a qualified opinion because of the omission. Auditors are not required to prepare the statement and include it in their report.

In those circumstances, SAS No. 58 at AU 508.44 states that the following report is appropriate.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the accompanying balance sheet of ABC Company (a Texas corporation) as of December 31, 20X1, and the related statements of income and retained earnings for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

The Company declined to present a statement of cash flows for the year ended December 31, 20X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by accounting principles generally accepted in the United States of America.

In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Omission of Comprehensive Income and Its Components

SFAS No. 130, *Reporting Comprehensive Income* (FASB ASC 220-10), requires comprehensive income and its components to be reported when a company presents a full set of financial statements that report financial position, results of operations, and cash flows. If a company issues financial statements that present financial position, results of operations, and cash flows but do not report comprehensive income and its components, auditors should issue a qualified opinion because of the omission. (Auditors are not required to prepare the comprehensive income information and include it in their report.) The following report is generally appropriate in those circumstances.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the accompanying balance sheet of ABC Company (a Texas corporation) as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

The Company declined to present comprehensive income and its components for the year ended December 31, 20X1. Presenting such information summarizing the change in the Company's equity during the period from transactions and other events and circumstances from nonowner sources is required by accounting principles generally accepted in the United States of America.

In our opinion, except that the omission of comprehensive income and its components results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

If the Company presents less than a full set of financial statements, it is believed that presenting comprehensive income and its components is optional providing that the omission of one or more statements required for a full set of financial statements does not, in and of itself, constitute a departure from GAAP. For example, GAAP does not preclude the following financial presentations, each of which is less than a full set of financial statements:

a. Stand-alone presentations of either a balance sheet, an income statement, or a statement of cash flows

b. Balance sheet and statement of cash flows

c. Income statement and statement of cash flows

Accordingly, when a company presents any of the financial presentations listed above, generally that omission of comprehensive income and its components would not constitute a departure from GAAP.

If the omission of one or more financial statements from a financial presentation is a departure from GAAP, however (such as presenting both a balance sheet and a statement of income, but omitting a statement of cash flows) it is believed that omission of comprehensive income and its components also is a departure from GAAP. In those circumstances, auditors should qualify their report for the omission of the statement of cash flows and comprehensive income information. An explanatory and opinion paragraph such as the following would be appropriate:

(explanatory paragraph—omission of statement of cash flows and presentation of comprehensive income)

The Company declined to present both a statement of cash flows and information about comprehensive income and its components for the year ended December 31, 20X1. Presenting such information summarizing the Company's operating, investing, and financing activities and the change in the Company's equity during the period from transactions and other events and circumstances from nonowner sources is required by accounting principles generally accepted in the United States of America.

(opinion paragraph)

In our opinion, except that the omission of the statement of cash flows and information about comprehensive income and its components results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Effect of an Accounting Standard before Its Effective Date

Although auditors *should not* qualify their report if a company does not adopt accounting principles that will be prescribed by an accounting standard before its effective date, assuming the company is currently following acceptable accounting principles, an auditing interpretation at AU 9410.13–.18 addresses the need for disclosure if (a) financial statements have been prepared in accordance with accounting principles that were acceptable at the financial statement date but will not be acceptable in the future and (b) the financial statements will be retrospectively adjusted in the future as a result of the change. The interpretation states that accountants should consider the potential effect of the change in evaluating whether disclosure of the impending change in accounting principle is essential for adequate disclosure. Best practices indicate that if retrospective adjustment will have a material effect on the financial statements, it should be disclosed for the financial statements to be in conformity with GAAP. If the impending change in accounting principle is not disclosed, auditors should modify their report for a departure from GAAP.

The authoritative literature does not address whether disclosure should be considered if the change to the new accounting principle is material and will be accounted for in financial statements of future periods, for example, prospectively. Best practices indicate that the financial statements should disclose a brief description of the new accounting principles and their effective date.

ACCOUNTING CHANGES

SAS No. 58 (AU 508) requires a reference to consistency in the auditor's report only when accounting principles have not been consistently applied. Thus, auditors need to evaluate changes in accounting principles to satisfy themselves that—

- a newly adopted principle is generally accepted,
- the method of accounting for the change is in conformity with GAAP, and
- management's justification for the change is reasonable.

If a change in accounting principle does not meet those criteria, the auditors should issue a qualified opinion because of the departure from GAAP.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. SAS No. 32, *Adequacy of Disclosure in Financial Statements,* indicates that when the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report. Which of the following accurately describes one of the guidelines used in considering the adequacy of disclosures?

   a. Financial statements should include information necessary for a fair presentation in conformity with GAAP.

   b. Adequate disclosure is generally characterized by extensive description.

   c. Disclosure is an acceptable substitute for a proper accounting measurement.

   d. Information disclosed in the notes is rarely limited to factual representations.

7. Which of the following statements regarding omission of comprehensive income and its components accurately describes a departure from GAAP?

   a. When stand-alone presentations of either a balance sheet, an income statement, or a statement of cash flows does not in and of itself constitute a departure from GAAP, omission of comprehensive income and its components would constitute a departure from GAAP.

   b. When presenting both a balance sheet and a statement of income, but omitting a statement of cash flows is a departure from GAAP, omission of comprehensive income and its components is also a departure from GAAP.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

6. SAS No. 32, *Adequacy of Disclosure in Financial Statements,* indicates that when the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report. Which of the following accurately describes one of the guidelines used in considering the adequacy of disclosures? **(Page 98)**

   a. Financial statements should include information necessary for a fair presentation in conformity with GAAP. [This answer is correct. Information essential for a fair presentation in conformity with GAAP should be set forth in the financial statements, including notes. Such information relates to the form, arrangement, and content of the financial statements and notes.]

   b. Adequate disclosure is generally characterized by extensive description. [This answer is incorrect. Extensive description or verbosity does not necessarily correlate to adequate disclosure. Adequate disclosure may be brief and concise.]

   c. Disclosure is an acceptable substitute for a proper accounting measurement. [This answer is incorrect. Disclosure is *not* a substitute for a proper accounting measurement. All measurements must be proper.]

   d. Information disclosed in the notes is rarely limited to factual representations. [This answer is incorrect. Information disclosed in the notes should generally be limited to factual representations. For instance, disclosing management's opinion about an event or transaction may cause the auditor to qualify the opinion on the financial statements.]

7. Which of the following statements regarding omission of comprehensive income and its components accurately describes a departure from GAAP? **(Page 101)**

   a. When stand-alone presentations of either a balance sheet, an income statement, or a statement of cash flows does not in and of itself constitute a departure from GAAP, omission of comprehensive income and its components would constitute a departure from GAAP. [This answer is incorrect. Presenting comprehensive income and its components is believed to be optional because the omission of the other statements required for a full set of financial statements does not, in and of itself, constitute a departure from GAAP.]

   b. When presenting both a balance sheet and a statement of income, but omitting a statement of cash flows is a departure from GAAP, omission of comprehensive income and its components is also a departure from GAAP. [This answer is correct. In this case, the omission of a statement of cash flows is a departure from GAAP, and so it is believed that omission of comprehensive income and its components is also a departure from GAAP. The auditor should qualify his or her report for both the omission of the statement of cash flows and comprehensive income information.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (GARTG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. SFAS No. 162 was replaced by:

   a. ARB No. 43.

   b. SFAS No. 168.

   c. SFAS No. 154.

   d. SFAS No. 162 was not replaced.

2. Which of the following statements regarding alternative sources of GAAP is accurate when criteria for selecting among alternative accounting principles have not been established by GAAP?

   a. When selecting a method for pricing inventory, the major objective should be to choose the one that, under the circumstances, most clearly reflects income for the period.

   b. When a new depreciation method better reflects the change in the pattern of consumption of benefits of an asset, an entity is justified in changing accounting estimate affected by the change in accounting principle.

   c. When more than one generally accepted accounting principle exists to account for a specific transaction, a company may make a change in accounting principle without justification.

   d. Do not select this answer choice.

3. When auditors have reached an affirmative conclusion that audited financial statements are not fairly presented in conformity with GAAP, a disclaimer of opinion is ________ an appropriate substitute.

   a. Always.

   b. Sometimes.

   c. Rarely.

   d. Never.

4. According to SAS No. 58 at AU 508.38, the effects of a GAAP departure on financial position, results of operations, and cash flows:

   a. Should never be disclosed.

   b. Generally should not be disclosed.

   c. Must be disclosed if practicable.

   d. Must always be disclosed.

5. If the auditor determines that an adverse opinion may need to be issued and cannot persuade the client to adjust the financial statements and is subsequently asked to withdraw from the audit, what is the auditor's responsibility regarding the dismissal, if any, to a successor auditor?

   a. The auditor has no responsibility, when asked, to a successor auditor if dismissed from the audit.

   b. The auditor has a responsibility, when asked, to relay the facts surrounding the dismissal to a successor auditor.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

6. Of the following statements regarding GAAP disclosure exceptions, which one is accurate?

   a. Auditors do not need to express a qualified or adverse opinion simply because accompanying notes to financial statements omit information required by GAAP.

   b. Omitted information is to be disregarded and not included in a separate paragraph of the auditor's report.

   c. Auditors frequently issue a qualified or adverse opinion as a result of inadequate disclosure.

   d. Auditors may issue a qualified opinion when the company being audited believes that certain disclosure requirements are not cost-beneficial to generate.

7. According to the text, which of the following is a common safeguard used by accountants to prevent the omission of disclosures required by GAAP?

   a. Prior experience.

   b. Consulting other auditors.

   c. Using a GAAP disclosure checklist.

   d. Multiple reviews of disclosures.

Lesson 2: Scope Limitations

INTRODUCTION

Authoritative Literature

The effect of limitations on the scope of audits of financial statements is discussed in SAS No. 58 at AU 508.22–.34.

The third standard of fieldwork states that "the auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit" (AU 150.02). Observance of that standard is reflected in the scope paragraph of the auditor's report, which states as follows:

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

Accordingly, when auditors are unable to apply procedures that they consider necessary in the circumstances, they are precluded from issuing an unqualified opinion.

Restrictions on the scope of the audit, whether imposed by the client or by circumstances such as the timing of audit work, inability to obtain sufficient appropriate audit evidence, or inadequacy of accounting records, may require auditors to qualify their opinion or to disclaim an opinion.

Circumstances such as the timing of audit work may make it impracticable or impossible to apply certain customary auditing procedures. In those cases, auditors should apply other auditing procedures to obtain appropriate satisfaction about important elements of the financial statements. If auditors are unable to satisfy themselves through alternative procedures, they must describe the scope limitation in an additional explanatory paragraph of their report preceding the opinion paragraph and refer to it in both the scope and opinion paragraphs of the report.

Learning Objectives:

Completion of this lesson will enable you to:

- Classify qualified opinions and disclaimers of opinion.
- Describe failure to confirm receivables or observe inventories.
- Define other scope limitations and when to withdraw from the engagement.

Qualify or Disclaim?

SAS No. 58 at AU 508.23 states that the decision to qualify or disclaim an opinion because of a scope limitation depends on the auditors' assessment of how important the omitted procedures are to their ability to form an opinion on the financial statements audited. That assessment is affected by the nature and magnitude of the potential effects of the matters in question and by their significance to the financial statements. If the potential effects relate to many financial statement items, their significance is likely to be greater than if only a limited number of items is involved.

If restrictions that significantly limit the scope of the audit are imposed by the client, auditors generally should disclaim an opinion on the financial statements.

Reference to a Note

It is *never* appropriate to have the company describe the scope limitation in notes to the financial statements and then to make reference to the note in the auditor's report. The description of the scope of the audit is the representation of the auditor, not of the client. Accordingly, all scope limitations should be disclosed in the auditor's report.

Scope Limitations versus GAAP Departures and Uncertainties

When auditors are faced with a limitation on the scope of their audit, they are unable to perform procedures they consider necessary to form a conclusion about whether the financial statements are fairly presented in conformity with GAAP. As a result, they do not know what, if any, adjustments should be made to the financial statements. When auditors are faced with a departure from GAAP, they have performed the procedures they consider necessary and have determined that adjustments should be made to the financial statements for them to conform to GAAP (even if the effects of the departure are not reasonably determinable). Therefore, a scope limitation qualification is not an appropriate substitute for a GAAP departure qualification.

Auditors should consider expressing a qualified opinion or disclaiming an opinion because of a scope limitation if audit evidence concerning an uncertainty (including its possible outcome or a reasonable estimate of the amount of an uncertainty classified as "probable") exists or did exist but is not available to them.

QUALIFIED OPINIONS

Report Format

When a qualified opinion is expressed because of a scope limitation, SAS No. 58 at AU 508.25 requires the situation to be described in a separate explanatory paragraph of the auditor's report preceding the opinion paragraph and referred to in both the scope and opinion paragraphs of the report.

Sample Report

The following is an example of an auditor's report qualified because of a scope limitation.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the accompanying balance sheet of ABC Company (a Texas corporation) as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

We were unable to obtain audited financial statements supporting the Company's investment in XYZ Corporation stated at $78,500 at December 31, 20X1, or its equity in XYZ Corporation's earnings of $12,300, which is included in net income for the year then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves about the carrying value of the investment or the equity in its earnings by other auditing procedures.[b]

In our opinion, except for[c] the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the investment and earnings of XYZ Corporation,[d] the financial statements referred to in the first paragraph[e] present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Notes:

[a] The scope paragraph refers to the scope limitation described in an explanatory paragraph.

[b] The report includes an explanatory paragraph preceding the opinion paragraph that describes the limitation on the scope of the audit. The description of the scope limitation should be worded to clearly state the reasons for the limitation. If the limitation resulted from conditions that preclude the application of procedures considered necessary in the circumstances, those conditions should be described, e.g., "we were appointed as auditors for the company after the date of the inventory" or "we were unable to confirm government receivables." The report always should state why the procedures were omitted to make clear that the omission was not of the auditors' choosing.

[c] Whenever an opinion is qualified because of a scope limitation, the qualification should include the word "except" or "exception" in a phrase such as "except for" or "with the exception of." It is believed that the qualifying phrase should be placed after the words "In our opinion." The opinion paragraph should not begin, "Except for . . ., in our opinion . . . ." nor should it state ". . . in conformity with generally accepted accounting principles, except for . . . ." Phrases such as "subject to" or "with the foregoing explanation" are not clear or forceful enough and should not be used.

[d] The opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself. Wording such as "except for the limitation on the scope of our audit described above" bases the exception on the restriction itself, rather than on the possible effects on the financial statements, and therefore is unacceptable.

[e] When an auditor's report contains an additional paragraph preceding the opinion paragraph, the authors prefer that the opinion paragraph specifically refer to the financial statements "in the first paragraph" instead of using the phrase "referred to above." The preferred wording avoids confusion that the opinion relates to any financial statements that may be mentioned in the explanatory paragraph.

DISCLAIMERS OF OPINION

Report Format

Disclaiming an opinion is appropriate when the scope of an audit is not sufficient to enable auditors to form an opinion on the financial statements. SAS No. 58 at AU 508.62 states that "when disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer." SAS No. 58 also requires that, in those circumstances, auditors state that the scope of their audit was not sufficient to warrant the expression of an opinion.

When disclaiming an opinion because of a scope limitation, auditors should keep the following points in mind:

- Auditors should never indicate the procedures that they performed nor include the paragraph describing the characteristics of an audit (i.e., the scope paragraph). Doing so could tend to overshadow the disclaimer. Describing the procedures that the auditors applied also could unintentionally increase the degree of responsibility that they are assuming, e.g., if their work is challenged in litigation, their responsibility could be based on a layman's interpretation of the reliance that should be placed on the work performed.

- If auditors are aware of departures from GAAP, AU 508.62 requires their report to disclose the departures even though the scope limitation precludes an expression of an opinion on the financial statements taken as a whole.

- SAS No. 58, AU 508.16–.18, requires auditors to disclose material changes in accounting principles in an explanatory paragraph following the opinion paragraph of their report. SAS No. 58 does not, however, specifically address whether a lack of consistency should be described in a separate explanatory paragraph when auditors disclaim an opinion on the financial statements taken as a whole. It is recommended that auditors disclose exceptions about consistency in their disclaimer report.

- SAS No. 26, AU 504.18 states that auditors should not contradict their disclaimer of opinion on the financial statements by expressing negative assurance, e.g., by stating that they are not aware of any departures from GAAP, unless such negative assurance is permitted by specific AICPA standards. (One example of an AICPA standard that allows expression of both a disclaimer and negative assurance in a report is a SSARS No. 1 review report.)

Sample Report

The following is an example of an auditor's disclaimer of opinion as a result of a scope limitation.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We were engaged to audit the accompanying balance sheets of ABC Company (a Texas corporation) as of December 31, 20X1 and 20X0, and the related statements of income, retained earnings, and cash flows for the years then ended.[a] These financial statements are the responsibility of the Company's management.[b]

The Company did not make a count of its physical inventory in 20X1 or 20X0, stated in the accompanying financial statements at $325,700 as of December 31, 20X1, and at $198,700 as of December 31, 20X0. Furthermore, evidence supporting the cost of property and equipment acquired prior to December 31, 20X0, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or to property and equipment.[c]

Since the Company did not take physical inventories and we were unable to apply other auditing procedures to satisfy ourselves about inventory quantities and the cost of property and equipment, as discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express,[d] and we do not express,[e] an opinion on the financial statements referred to in the first paragraph.

Notes:

[a] Because the report disclaims an opinion on the financial statements, the first sentence of the introductory paragraph states "We were engaged to audit . . ." rather than "We have audited . . ."

[b] The introductory paragraph omits the reference to the auditors' responsibility, and the scope paragraph is omitted.

[c] The separate explanatory paragraph preceding the opinion paragraph explains the substantive reasons for the auditors' disclaimer of opinion and describes the respects in which their audit did not comply with generally accepted auditing standards. AU 508 also requires the disclaimer report to disclose any GAAP departures that the auditors are aware of. It is recommended that auditors also disclose any inconsistencies.

[d] The concluding paragraph of the report states that the scope of the audit was not sufficient to warrant the expression of an opinion.

e The concluding paragraph clearly states that the auditors do *not express* an opinion on the financial statements.

Disclaimer of Opinion on One or More, but Not All, Basic Financial Statements

Auditors may encounter situations in which they must disclaim an opinion on one or more, but not all, basic financial statements, yet a complete set of financial statements is to be presented. The reporting requirements in those situations are governed by the nature of the engagement. If the auditors have been engaged to express an opinion on only the balance sheet (when all basic financial statements are presented), they should disclaim an opinion on the financial statements they did not audit and express an opinion on the balance sheet only. That type of engagement, referred to as a "limited reporting engagement," does *not* involve a scope limitation.

In contrast, if the auditors have been engaged to audit the complete set of financial statements, but conditions prevent them from expressing an opinion on one or more of the basic financial statements, they must modify their report for a scope limitation. For example, inadequate sales records may prevent auditors from expressing an opinion on the statements of income, retained earnings, and cash flows. However, the accounting information underlying the balance sheet may be adequate for expressing an opinion on the balance sheet alone. Because the company engaged the auditors to audit all of the basic financial statements, but conditions precluded them from doing so, the auditors must modify their report for a scope limitation.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. Scope limitations should be disclosed in which of the following ways?

   a. By the client in notes to the financial statements and then referenced in the auditor's report.

   b. Only by the auditor in the auditor's report.

9. Which of the following actions by the auditor is appropriate when disclaiming an opinion because of a scope limitation?

   a. Auditors should always indicate the procedures that they performed and include the paragraph describing the characteristics of the audit.

   b. Auditors that are aware of departures from GAAP are not required to disclose the departures in their report since the scope limitation precludes an expression of an opinion on the financial statements taken as a whole.

   c. Disclosing material changes in accounting principles in an explanatory paragraph following the opinion paragraph of the auditor's report is at the auditor's discretion.

   d. Auditors should not contradict their disclaimer of opinion on the financial statements by expressing negative assurance.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

8. Scope limitations should be disclosed in which of the following ways? **(Page 107)**

   a. By the client in notes to the financial statements and then referenced in the auditor's report. [This answer is incorrect. It is never appropriate to have the company/client describe the scope limitations in notes to the financial statements and then to make reference to the note in the auditor's report because the scope of the audit is the representation of the auditor, not of the client.]

   b. Only by the auditor in the auditor's report. [This answer is correct. The description of the scope of the audit is the responsibility of the auditor, not the client. Therefore, all scope limitations should be disclosed in the auditor's report.]

9. Which of the following actions by the auditor is appropriate when disclaiming an opinion because of a scope limitation? **(Pages 109)**

   a. Auditors should always indicate the procedures that they performed and include the paragraph describing the characteristics of the audit. [This answer is incorrect. Auditors should *never* indicate the procedures that they performed nor include the paragraph describing the characteristics of an audit. Such action might overshadow the disclaimer.]

   b. Auditors that are aware of departures from GAAP are not required to disclose the departures in their report since the scope limitation precludes an expression of an opinion on the financial statements taken as a whole. [This answer is incorrect. If auditors are aware of departures from GAAP, SAS No. 58, AU 508.62 requires their report to disclose the departures even though the scope limitation precludes an expression of an opinion on the financial statements taken as a whole.]

   c. Disclosing material changes in accounting principles in an explanatory paragraph following the opinion paragraph of the auditor's report is at the auditor's discretion. [This answer is incorrect. SAS No. 26 AU 508.16–.18 *requires* auditors to disclose material changes in accounting principles in an explanatory paragraph following the opinion paragraph of their report.]

   d. Auditors should not contradict their disclaimer of opinion on the financial statements by expressing negative assurance. [This answer is correct. SAS No. 26, AU 504.18 indicates that auditors should not contradict their disclaimer of opinion on the financial statements by expressing negative assurance such as by stating that they are not aware of any departures from GAAP, unless such negative assurance is permitted by specific AICPA standards.]

FAILURE TO OBSERVE INVENTORIES OR CONFIRM RECEIVABLES

Authoritative Literature—Accounts Receivable

SAS No. 67, *The Confirmation Process*, defines accounts receivable at AU 330.34 as "(a) the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business and (b) a financial institution's loans." The SAS states:

> Confirmation of accounts receivable is a generally accepted auditing procedure. . . . Thus, there is a presumption that the auditor will request the confirmation of accounts receivable during an audit unless one of the following is true:
>
> - Accounts receivable are immaterial to the financial statements.
> - The use of confirmations would be ineffective.
> - The auditor's combined 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 for the applicable financial statement assertions.

Unless one of these conditions is met, auditors should confirm accounts receivable as part of a GAAS audit.

Confirmations Would Be Ineffective. Auditors may have prior experience with the client or with clients in similar industries that would lead them to conclude that response rates to properly designed confirmation requests will be inadequate or that responses are expected to be unreliable. Therefore, the auditors may determine that confirming accounts receivable would be ineffective and, therefore, not perform those procedures. In that case, however, the auditors would obtain evidence about assertions related to accounts receivable from other sources.

Combined Risk Assessment Is Low. The greater the combined assessed level of inherent and control risk, the greater the assurance that the auditor needs from substantive tests related to financial statement assertions. Conversely, the lower the auditors assess inherent and control risk for significant assertions related to accounts receivable, the less audit evidence they need from substantive procedures. In the latter case, SAS No. 67 (AU 330) states that audit risk for applicable financial statement assertions related to accounts receivable may be reduced to a sufficiently low level without performing confirmation procedures. Note, however, that the SAS does require auditors to perform some type of substantive procedures (e.g., analytical procedures) to achieve an acceptably low level of audit risk for the related assertions.

Receivables Not Confirmed

Notwithstanding the guidance above, when a scope limitation prevents auditors from confirming accounts receivable, the following rules generally apply:

- If the auditors are unable to satisfy themselves by applying other auditing procedures and believe the failure to confirm receivables significantly affects their ability to form an opinion on the financial statements, they should qualify their opinion or disclaim an opinion on the financial statements, depending on the materiality of the amounts involved.
- If receivables are not confirmed due to restrictions imposed by the company, and receivables are material, the auditors should disclaim an opinion on the financial statements.

Certain Categories of Receivables Not Confirmed

If the scope limitation relates only to certain categories of receivables, auditors may indicate parenthetically, in the description of the scope limitation in the explanatory paragraph, the aggregate amount of receivables that were not confirmed. If the limitation relates to an item that can be identified in the balance sheet, e.g., all receivables or a class of receivables shown separately, it is not necessary to indicate the amount in the auditor's report.

Client Requests Not to Send Confirmations

Occasionally clients might request that auditors refrain from confirming account balances or other information due to a dispute between the client and the customer or for other reasons. Before agreeing to the client's request, auditors should consider it with an attitude of professional skepticism and consider whether the request has any implications regarding management integrity and whether it might indicate the possible existence of fraud. Generally, auditors should not rely solely on the client's representation about the reasons for the request not to send external confirmations but should attempt to obtain corroborating evidence to support the request's validity. If the auditors agree with the client's request, they should apply alternative procedures to obtain sufficient evidence about the subject matter of the confirmation. In that case, best practices indicate there is no limitation of the scope of the audit, and the auditors should issue an unqualified opinion. (The auditor's report should not include a reference to the omission of external confirmations or to the use of alternative procedures.)

On the other hand, if the auditors do not consider the client's request to be reasonable and they are prohibited from confirming account balances or other information, best practices indicate there is a scope limitation imposed by the client, and, accordingly, the auditors should disclaim an opinion on the financial statements. If the auditors believe the client's request has implications regarding management integrity or might indicate the possible existence of fraud, they should consult with their attorney and consider withdrawing from the engagement.

Authoritative Literature—Observation of Inventories

SAS No. 1 at AU 331.01 states:

> Observation of inventories is a generally accepted auditing procedure. The independent auditor who issues an opinion when he has not employed them must bear in mind that he has the burden of justifying the opinion expressed.

Ending Inventory Observation Omitted

To express an unqualified opinion, SAS No. 1 at AU 331.09 requires auditors to observe inventory and make some test counts. When auditors are engaged to audit a company's financial statements after the balance sheet date and, therefore, are unable to observe the counting of the inventory at the company's year end, tests of accounting records and analytical procedures cannot provide sufficient audit evidence. Alternative procedures must involve physical contact with the inventory, e.g., observing a post-balance sheet physical inventory and, by considering transactions occurring after the year-end, substantiating the inventory balance at the balance sheet date.

When auditors are unable to observe the counting of the physical inventory at the balance sheet date, the following rules generally apply:

- If auditors are able to apply alternative procedures that involve physical contact with the inventory, e.g., observing a post-balance sheet inventory and making test counts, and testing intervening transactions, they may issue an unqualified opinion.
- If auditors are unable to satisfy themselves by applying other auditing procedures, they should either qualify their opinion or disclaim an opinion on the financial statements, depending on the materiality of the amounts involved. (Warning: Tests of accounting records and analytical procedures alone are not sufficient alternative procedures. AU 331.12 specifically states that "it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions.")
- If auditors are unable to observe inventories because of a restriction imposed by the client, and inventories are material, they should disclaim an opinion on the financial statements.

DEALING WITH FIRST AUDITS

Beginning Inventory Not Observed

In a first audit of a company's financial statements, a question often arises concerning what, if anything, must be said in the auditor's report if it was not possible to observe the taking of the physical inventory at the beginning of the period. The fact that opening inventory was not observed does not, in itself, require auditors to qualify their opinion or to disclaim an opinion. Generally accepted auditing standards indicate that if circumstances make it impossible or impracticable for the auditors to observe physical inventories, there is no significant limitation on the scope of the audit so long as the auditors are able to satisfy themselves about the inventories by applying alternative procedures. SAS No. 1 at AU 331.13 states that auditors may be able to become satisfied about beginning inventories through appropriate procedures such as tests of prior transactions, reviews of the records of prior counts, and gross profit tests, *provided that they have been able to become satisfied about the current (ending) inventory*. In those cases, the auditor's report need not refer to the failure to observe beginning inventories.

In some initial audits, the company's financial statements for the prior year may have been audited by other reputable auditors who observed beginning physical inventory counts. If the auditors review the inventory observation work of the other auditors (including a review of the prior auditors' workpapers) and find no reason to question it, they may issue an unqualified opinion without stating that they did not observe the counting of the opening inventory, provided that they have been able to become satisfied about the current (ending) inventory.

Best practices indicate auditors should exercise caution when there has been no observation of beginning inventories or no reliance can be placed on the predecessor auditor's observation. In situations where beginning inventories are material, inventory transactions throughout the period are numerous, or the mature and major components of inventories have changed during the period under audit, it may be difficult to reduce audit risk to a sufficiently low level through the use of alternative procedures to issue an unqualified opinion. Accordingly, if the auditors are not able to obtain satisfaction regarding the beginning inventory (or if the financial statements for the prior year were not audited), they must consider qualifying their opinion or disclaiming an opinion on some or all of the financial statements.

Frequently in first audits, the auditors express an opinion on the balance sheet only and either qualify their opinion or disclaim an opinion on the income statement and statement of cash flows.

Consistency

SAS No. 58, AU 508.16, states that "the auditor's standard report implies that the auditor is satisfied that the comparability of financial statements between periods has not been materially affected by changes in accounting principles and that such principles have been consistently applied between or among periods . . . ." When auditors have not audited the financial statements of a company for the preceding year, they may have to extend their auditing procedures to form an opinion about whether accounting principles have been consistently applied. If companies maintain adequate accounting records, auditors usually are able to extend their auditing procedures sufficiently to satisfy themselves about consistency.

When inadequate accounting records or other limitations preclude auditors from forming an opinion about consistency or about the amounts of assets or liabilities at the beginning of the period, they may be unable to express an opinion on the current year's results of operations and cash flows.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

10. As part of a GAAS audit, the auditor must request the confirmation of accounts receivable if which of the following conditions exist?

    a. Accounts receivable are material to the financial statements.

    b. Even if the use of confirmations would be ineffective.

    c. The auditor's combined assessed level of inherent and control risk is low.

11. If auditors are unable to observe the counting of physical inventory at the balance sheet date, which of the following rules in SAS No. 1 at AU 331.09 applies?

    a. If auditors have to apply alternative procedures that involve physical contact with the inventory, they should qualify their opinion.

    b. If auditors are unable to satisfy themselves by applying other auditing procedures, they should either qualify their opinion or disclaim an opinion on the financial statements.

    c. If auditors are unable to observe inventories because of a restriction imposed by the client, and inventories are material, they should qualify their opinion.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

10. As part of a GAAS audit, the auditor must request the confirmation of accounts receivable if which of the following conditions exist? **(Page 115)**

    a. Accounts receivable are material to the financial statements. [This answer is correct. According to SAS No. 67, the auditor *will* request the confirmation of accounts receivable during an audit if accounts receivable are material to the financial statements.]

    b. Even if the use of confirmations would be ineffective. [This answer is incorrect. The auditor will generally *not* request the confirmation of accounts receivable during an audit if the use of confirmation would be ineffective per SAS No. 67, *The Confirmation Process*. The auditors would obtain evidence about assertions related to accounts receivable from other sources.]

    c. The auditor's combined assessed level of inherent and control risk is low. [This answer is incorrect. Per SAS No. 67, the auditor will generally *not* request the confirmation of accounts receivable during an audit if the auditor's combined assessed level of inherent and control risk is low, and the assessed level is sufficient to reduce audit risk to an acceptably low level for the applicable financial statement assertions.]

11. If auditors are unable to observe the counting of physical inventory at the balance sheet date, which of the following rules in SAS No. 1 at AU 331.09 applies? **(Page 116)**

    a. If auditors have to apply alternative procedures that involve physical contact with the inventory, they should qualify their opinion. [This answer is incorrect. If auditors are able to apply alternative procedures that involve physical contact with the inventory, they may issue an unqualified opinion.]

    b. If auditors are unable to satisfy themselves by applying other auditing procedures, they should either qualify their opinion or disclaim an opinion on the financial statements. [This answer is correct. If auditors are unable to satisfy themselves by applying other auditing procedures, they should either qualify their opinion or disclaim an opinion on the financial statements, depending on the materiality of the amounts involved. Per AU 331.12, some physical counts of the inventory and application of appropriate tests of intervening transactions are necessary.]

    c. If auditors are unable to observe inventories because of a restriction imposed by the client, and inventories are material, they should qualify their opinion. [This answer is incorrect. If auditors are unable to observe inventories because of a restriction imposed by the client, and inventories are material, they should disclaim an opinion on the financial statements per SAS No. 1 at AU 331.09.]

OTHER SCOPE LIMITATIONS

Procedures Required by GAAS

Auditors may wonder whether there are any specific procedures that generally accepted auditing standards require them to perform in order to express an opinion that is not modified for a scope limitation on the financial statements. The failure to confirm accounts receivable or to observe inventories does not automatically result in a scope limitation. The following are examples of some specific procedures that generally accepted auditing standards require auditors to perform:

- Prior to the acceptance of an engagement, successor auditors should evaluate certain communications with predecessor auditors (SAS No. 84 at AU 315.03).

- Auditors should obtain information from management regarding litigation, claims, and assessments and corroborate that information through letters of inquiry to the company's lawyers (AU 337.05–.08).

- Auditors are required to obtain written representations from management. SAS No. 85 (AU 333.13) states that management's refusal to furnish written representations constitutes a scope limitation "sufficient to preclude an unqualified opinion."

- Auditors should consider certain procedures to identify related party relationships and transactions and to satisfy themselves concerning the required financial statement accounting and disclosure (AU 334.01).

Obviously, auditors may not conclude that simply because they have applied the preceding procedures, they have performed an audit of financial statements in accordance with generally accepted auditing standards. The procedures must be supplemented with others that the auditors consider necessary. Failure to apply those procedures, however, would almost certainly result in a qualified opinion or a disclaimer of opinion because of a scope limitation. For example, AU 333.13 states that failure to obtain a management representation letter precludes an unqualified report, and AU 337.13 states that a lawyer's refusal to furnish the information requested in an inquiry letter also would be a scope limitation sufficient to preclude an unqualified opinion. Auditors' *inability* to perform procedures required by GAAS, such as agreeing financial statements to underlying accounting records or reviewing journal entries, for example, due to inadequate client records, also may result in a scope limitation.

Management Representation Letters

SAS No. 85 at AU 333 requires auditors to obtain certain written representations from the company as part of every engagement conducted in accordance with generally accepted auditing standards. In addition, if comparative financial statements are presented, SAS No. 85 states that the representations should cover all periods audited. Also, the representation letter should be signed by the *current* owner/manager. If the owner/manager changed during or after the period(s) under audit, the current owner/manager may be hesitant to provide this assurance. While, in some cases, it may be possible to obtain representations from the previous owner/manager, it is unlikely, and the auditor still should obtain representations for all periods from the current owner/manager. Auditors may point out to the client that the representations are based on the client's "best knowledge and belief."

SAS No. 85 states that management's refusal to furnish written representations is a limitation on the scope of the audit sufficient to preclude an unqualified opinion. In some circumstances, the owner/manager may sign the representation letter, but a controller who was not present during the period under audit may decline because he is new to the situation. Generally that circumstance would not result in a scope limitation; however, the auditor should make inquiries to determine that the reason for the controller not signing the letter is because the controller was not responsible for the financial statements and not due to other reasons, such as disagreement about accounting matters or knowledge of an actual or suspected material misstatement. Generally, the controller should be asked to sign a separate representation in that circumstance stating that he has no knowledge of a material matter that was not properly treated in the financial statements.

SAS No. 85 states that management's refusal to furnish written representations ordinarily causes auditors to disclaim an opinion or withdraw from the engagement unless they conclude that a qualified opinion is appropriate because of the nature of the representations that have not been obtained or the circumstances surrounding the refusal to provide the representations. In rare situations, such as where the letter is not signed by all members of management or a company is being audited in connection with a proposed acquisition, the auditors may be satisfied that the company is not attempting to conceal facts, and a qualified opinion may be appropriate. Generally, however, in the vast majority of situations, the inability to obtain written representations is a scope limitation imposed by the client, and thus a disclaimer of opinion should be issued. If management refuses to sign a management representation letter, a compilation or a review report cannot be substituted for a qualified opinion or a disclaimer of opinion (SSARS No. 1 at AR 100.76).

When the company refuses to furnish written representations that the auditors consider necessary, the auditors should carefully consider the reasons for the company's refusal. Also, they should consider its effect on their ability to rely on other representations, both written and oral.

Even when the company has given written representations concerning a material matter, the auditors' inability to perform procedures they consider necessary with respect to that material matter constitutes a scope limitation, causing them to qualify their opinion or disclaim an opinion.

Management's representation letter should be dated as of the date of the auditor's report on the financial statements. AICPA Technical Practice Aid, *The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report* (TIS 9100.06–.07), clarifies that the requirement does not mean that the auditor needs to physically have management's representation letter on the date of the auditor's report. However, on or before the date of the auditor's report, management will need to have reviewed the final representation letter and confirmed to the auditor that they will sign the letter. The auditor will need to have the signed management representation letter prior to releasing the auditor's report since management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

Lawyers' Letters

SAS No. 12 at AU 337.08 states that "a letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments." An auditing interpretation at AU 9337.15–.17, *Client Has Not Consulted a Lawyer*, indicates that a scope limitation usually does not result, however, if the company has not consulted a lawyer. In those circumstances, auditors normally would rely on the review of internally available information and written representations from management regarding litigation, claims, and assessments. However, if auditors become aware of information that indicates potentially material litigation, claims, or assessments, they should discuss the need to consult legal counsel with the client. If the client refuses and the auditors believe material amounts may require accrual or disclosure, they usually should modify their opinion because of the scope limitation. In those circumstances, it is believed that a disclaimer of opinion generally should be issued, because the limitation on the scope of the audit has been imposed by the client. If the client prohibits auditors from corresponding with the company's legal counsel, a compilation or a review report cannot be substituted for a qualified opinion or a disclaimer of opinion (SSARS No. 1).

SAS No. 12 at AU 337.12 recognizes that lawyers usually will limit their response to "matters to which he has (they have) given substantive attention in the form of legal consultation or representation." It also recognizes that lawyers' responses are limited to matters that, individually or collectively, are considered to be material to the financial statements (provided the lawyer and the auditors have reached an understanding on the limits of materiality for such purposes). These are *not* limitations on the scope of the audit.

A lawyer's refusal to furnish information requested in a letter of inquiry, either in writing or orally, would, however, be a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

On the other hand, an auditing interpretation at AU 9337.18–.23, *Assessment of a Lawyer's Evaluation of the Outcome of Litigation*, indicates that a lawyer's inability to give an unequivocal evaluation of the likelihood that litigation will be resolved unfavorably constitutes an uncertainty rather than a scope limitation. In those circumstances, the auditing interpretation notes that auditors should consider the guidance at AU 508.45–.49 to determine if the lawyer's response will affect the auditor's report. That guidance would require auditors to express a qualified or adverse opinion if (a) disclosure of a material uncertainty is inadequate, (b) the accounting principles used to estimate the loss related to the uncertainty are inappropriate, or (c) management's estimates of the effects of the uncertainty are unreasonable.

Some clients emphasize the preservation of the attorney-client privilege in the letter of audit inquiry. Their letters may include such language as the following:

> We do not intend either this request or your response to our auditor to constitute a waiver of the attorney-client privilege or the attorney work-product privilege.

Also, some attorneys include similar explanatory language in their responses. Here is an example:

> The Company has advised us that the request made in its letter to us is not intended to be a waiver of the attorney-client privilege with respect to any information the Company has furnished to us. Moreover, please be advised that our response to you should not be interpreted as a waiver of the protection of the attorney work-product privilege with respect to any of our files involving the Company.

In those situations, questions arise about whether the explanatory language about the attorney-client privilege or the attorney work-product privilege results in a limitation on the scope of the audit. An auditing interpretation at AU 9337.28–.29, *Use of Explanatory Language About the Attorney-Client Privilege or the Attorney Work-Product Privilege*, states that such explanatory language in the letters of the client or the attorney does not result in a scope limitation.

Some attorneys also include language such as the following in their responses to emphasize the preservation of attorney-client privilege:

> Please be advised that pursuant to clauses (b) and (c) of paragraph 5 of the ABA Statement of Policy and related Commentary referred to in the last paragraph of this letter, it would be inappropriate for this firm to respond to a general inquiry relating to the existence of unasserted possible claims or assessments involving the company. We can only furnish information concerning those unasserted possible claims or assessments upon which the company has specifically requested in writing that we comment. We also cannot comment upon the adequacy of the company's listing, if any, of unasserted possible claims or assessments or its assertions concerning the advice, if any, about the need to disclose same.

According to an interpretation of SAS No. 12 (AU 9337.31–.32), such language is not a limitation on the scope of the audit as long as the lawyer's response includes a confirmation of the understanding that the lawyer, under certain circumstances, will advise and consult with the client concerning the client's obligation to make financial statement disclosure with respect to unasserted claims or assessments.

Inadequate Records

Current-year Records. Occasionally, auditors may be unable to complete an audit because the company's accounting records are inadequate. In those circumstances, the auditors should consider whether they should:

- express a qualified opinion,
- disclaim an opinion because of the magnitude of the possible misstatement of the financial statements that could remain undetected, or
- withdraw from the engagement.

Prior-year Records. In an initial audit, inadequate records for prior years may preclude auditors from becoming satisfied about the amount at which opening balances are stated, and they may need to qualify their opinion or disclaim an opinion on one or more of the basic financial statements of the current year. Lack of adequate records supporting the opening balance of a balance sheet account may require a qualification or a disclaimer on the current year's income statement or the statement of cash flows.

Inadequate accounting records for the prior year generally would preclude auditors from determining that generally accepted accounting principles have been consistently applied. That circumstance would require the auditors to disclaim an opinion about consistency.

Even though some auditors express qualified opinions for a scope limitation when accounting records are inadequate, it is believed that inadequate accounting records are a scope limitation imposed by the client and that, as such, a disclaimer of opinion generally should be expressed.

Destruction of Documents. Auditors may be unable to complete an audit because the company's accounting records have been destroyed by fire, flood, or other natural disaster either prior to the start of audit procedures or during the audit. Subsequent to the devastation caused by Hurricane Katrina, the AICPA released a Technical Practice Aid at TIS 8345 to address how the destruction of evidence supporting the financial statements affects the auditor's procedures and the auditor's report. TIS 8345 confirms that the auditor must be able to perform procedures sufficient to provide a reasonable basis for an opinion on the financial statements being audited. If substantially all of a company's evidence supporting its financial statements has been destroyed and the auditor is unable to complete the audit, the auditor should disclaim an opinion on the financial statements. TIS 8345 also includes guidance for auditors when it is their audit documentation that has been destroyed by fire, flood, or natural disaster rather than the client's accounting records.

Pension Plans

Under Department of Labor regulations, a plan administrator that is a bank, similar institution, or insurance carrier and is regulated, supervised, and subject to periodic examination by a state or federal agency may restrict an audit of the assets held and transactions executed by them if that information is certified as complete and accurate by the plan administrator. (Auditors should be aware, however, that the scope restriction does not extend to benefits or other information not certified by a qualified trustee or custodian (e.g., real estate, mortgages, and participation loan: may not be covered by certification). Audit procedures still must be performed on areas not covered by the plan administrator's certificate.)

Related Party Transactions

SFAS No. 57, *Related Party Disclosures*, (FASB ASC 850-10-50-5) states that representations about related party transactions should not imply that they were consummated on terms equivalent to those that prevail in arm's length transactions unless they can be substantiated. If the auditors believe that management is unable to substantiate such a representation included in financial statements, they should qualify their opinion because of a departure from GAAP rather than because of a scope limitation. Accordingly, in those circumstances, a qualified or adverse opinion should be expressed, depending on materiality. An AICPA auditing interpretation (AU 9334.22–.23) further clarifies that prefacing such a representation included in the financial statements with a phrase such as "Management believes" or "It is the Company's belief" does not change management's responsibility to substantiate the representation.

Investments

An AICPA auditing interpretation, *Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist*, at AU 9332.01–.04, primarily addresses the evidence that auditors are required to obtain to support the fair market value of an investment in a hedge fund that an entity reports at fair value but for which a readily determinable fair value does not exist. The interpretation states that under certain conditions, auditors may substantiate the existence of the investment through confirmation with the hedge fund; however, a confirmation from the hedge fund regarding the fair value of the investments does not, in and of itself, constitute adequate audit evidence with respect to the valuation of the investments. In those circumstances, SAS No. 101, *Auditing Fair Value Measurements and Disclosures*, at AU section 328, discusses the auditor's procedures for substantiating fair value which include (a) understanding the entity's process for determining fair value measurements and disclosures and the relevant controls, and assessing risk, (b) evaluating conformity of the fair value measurements and disclosures with GAAP, (c) engaging a specialist, where necessary, (d) testing the entity's fair value measurements and disclosures, (e) evaluating the entity's disclosures with respect to fair values, (f) evaluating the results of audit procedures, (g) obtaining management representations, and (h) communicating with those charged with governance. If the auditor is unable to substantiate the existence or valuation of investments in securities, a scope limitation exists which generally would require the auditor to either issue a qualified opinion or disclaim an opinion on the financial statements.

Entities Under Common Control

In some circumstances, auditors are engaged to audit some, but not all, entities under common control. Although valid business reasons might preclude auditors from providing services to all related entities under common control, they are nonetheless required to obtain sufficient appropriate audit evidence to ensure all material transactions among the entities are appropriately reflected in the financial statements. Auditors will generally find it necessary to have discussions with management and those charged with governance to understand the nature of the operations of the controlled group, the types of transactions executed among the entities, and the transactions between members of the group and controlling persons. (Based on the circumstances, auditors also might decide that other procedures are necessary including inquiries of predecessor or continuing accountants that are or have been associated with members of the group or reading relevant documents, such as leases or contracts.) If the auditors are unable to obtain sufficient support to ensure that all material transactions among the related entities are appropriately reflected in the financial statements they have been engaged to audit, they should consider modifying their report on the financial statements because of a scope limitation. If the auditors believe that the client has limited or denied them access to information, it is believed that the auditors should consider whether there are implications regarding management integrity and whether it might indicate the possible existence of fraud. In those circumstances, it is recommended that the auditors consider withdrawing from the engagement and should also consult with their legal counsel.

Special-purpose Reports on Internal Control at Service Organizations

SAS No. 70 (AU 324), *Service Organizations*, recognizes that an entity may use a service organization to provide services that are part of the entity's information system. SAS No. 70 provides guidance on the effects of a service organization's controls on the auditor's considerations when obtaining an understanding of the entity and its environment, including its internal controls, and when performing auditing procedures. Whether the auditor considers the service organization's controls depends on whether the client has effective controls over transactions processed by the service organization and whether the auditor can plan and perform auditing procedures without considering the service organization's controls. In some cases, the auditor may be unable to reduce to an appropriately low level audit risk for certain assertions in the financial statements without identifying one or more controls placed in operation by the service organization and gathering audit evidence about their operating effectiveness.

Generally, user auditors obtain an understanding of a service organization's controls by requesting specific information (for example, user manuals, system overviews, or reports by service auditors) from the service organization or by visiting the service organization and performing certain procedures themselves. If the user auditors are unable to obtain sufficient evidence to achieve their audit objectives, however, the user auditors should qualify their opinion or disclaim an opinion on the financial statements because of a scope limitation.

Using the Work of Specialists

SAS No. 73 (AU 336), *Using the Work of a Specialist*, discusses situations in which auditors may use the work of a specialist and procedures they should apply to determine whether the specialist's findings support the related assertions in the financial statements. SAS No. 73 applies in the following circumstances:

- Management engages or employs a specialist and the auditor uses that specialist's work as audit evidence in performing substantive tests to evaluate material financial statement assertions.

- Management engages a specialist employed by the auditor's firm to provide advisory services and the auditor uses that specialist's work as audit evidence in performing substantive tests to evaluate material financial statement assertions.

- The auditor engages a specialist and uses that specialist's work as audit evidence in performing substantive tests to evaluate material financial statement assertions.

SAS No. 73 does not apply to specialists employed by the auditor's firm or to outside professionals who effectively function as members of the audit team. For example, if the auditor's firm employs an appraiser as part of the audit team to evaluate the carrying values of properties, SAS No. 73 does not apply. SAS No. 108, *Planning and Supervision*, applies in that situation. Also, if the auditor uses an IT specialist, whether employed by the auditor's firm or on a contract basis, as part of the audit team to help determine the effect of information technology on the audit, understand the entity's controls, or design and perform tests of controls (when applicable) and substantive tests, SAS No. 108, rather than SAS No. 73, applies to the work of the specialist.

If the auditors determine that the specialist's findings support the related financial statement assertions, they may reasonably conclude that they have obtained sufficient appropriate audit evidence. If there is a material difference between the specialist's findings and the assertions in the financial statements, however, AU 336 states that auditors should apply additional procedures. If, after applying such procedures, the auditors are unable to resolve the matter, they should consider obtaining the opinion of another specialist, unless it appears that the matter is unable to be resolved. An unresolved matter ordinarily will cause the auditors to conclude that they should qualify their opinion or disclaim an opinion on the financial statements because of a scope limitation.

AU 336 states that, generally, auditors will not make reference to the work or findings of a specialist in their audit report. AU 336 points out that such a reference might be misunderstood to be a qualification of the auditors' report or a division of responsibility, neither of which is intended. It does, however, allow auditors to refer to and/or identify the specialist in their report if they believe that such statements will enable users to better understand the reasons for (a) adding an explanatory paragraph to the report or (b) departing from an unqualified opinion. It is believed such instances will be rare in practice. Thus, auditors' reports containing qualified opinions or disclaimers of opinion because of a scope limitation as discussed in the preceding paragraph are likely to look the same as other qualified reports and disclaimers of opinion for scope limitations.

Furthermore, if an entity does not have the specialized skills or knowledge needed in particular circumstances to prepare financial statements in conformity with GAAP and declines to employ or engage a specialist, the auditor should consider whether the circumstances are a limitation on the scope of the audit imposed by the client and, as such, require the auditor to disclaim an opinion on the financial statements. In those circumstances, the auditor should also consider whether the entity's failure to engage or employ a specialist constitutes a material weakness in internal control.

Fair Value and Other Estimates

The auditor's responsibility with respect to fair value measurements included in financial statements is to obtain sufficient audit evidence to provide reasonable assurance that the fair value measurements and disclosures are in conformity with GAAP. Standards for auditing fair value information are provided in AU section 328, *Auditing Fair Value Measurements and Disclosures*, and AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

Some fair value measurements are inherently less uncertain and accordingly audit evidence supporting the measurements may be more relevant and reliable. Other fair value measurements, such as for derivatives that are not publicly traded or for which a highly specialized entity developed model is used or for which there are assumptions or inputs that can not be observed in the marketplace are inherently subject to more uncertainty. Furthermore, general economic conditions, such as illiquidity in a particular market, may affect the degree of uncertainty in fair value estimates. One characteristic of the recent economic and financial crisis is illiquid and inactive markets for securities and other financial instruments. As a consequence, accountants and auditors have expressed concern about the appropriate application of fair value accounting standards.

To address those concerns, the FASB has issued the following guidance that clarifies fair value accounting and disclosure in those circumstances:

- FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (FASB ASC 820-10-35-15A; 820-10-35-55A and 55B; 820-10-35-65-2)
- FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FASB ASC 820-10-65-4)
- FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (FASB ASC 320-10-65-1)
- FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (FASB ASC 825-10-65-1)

In addition, the AICPA Audit Risk Alert, *Current Economic Crisis: Accounting and Auditing Considerations*, which was issued to help auditors identify and respond to accounting and auditing issues related to the current economic environment, including those related to fair value accounting, provides guidance about procedures to audit fair value, including procedures to perform when an observable market price is not available.

Fair value estimates included in financial statements of most nonpublic companies generally are subject to reasonable estimation and are supported by sufficient appropriate audit evidence. However, in some cases, the uncertainty associated with a fair value estimate may be so great that it is difficult for auditors to obtain sufficient appropriate audit evidence that the fair value estimates and disclosures are in conformity with GAAP. In some cases, it may be necessary to use a specialist, such as a securities valuation expert, to assist in auditing fair value estimates. Auditors should not conclude, however, that a difficulty in obtaining audit evidence about fair value estimates recorded in the financial statements constitutes a limitation on the scope of their audit. When amounts required by GAAP to be recorded in the financial statements are omitted and such amounts are material, including when the amounts are not reasonably determinable, auditors should modify their report for a departure from GAAP.

In addition to fair value estimates, estimates such as the following also may require additional evaluation in the current economic environment: allowance for uncollectible accounts receivable, the impairment analysis and estimated useful lives of long-lived assets, the valuation allowance of deferred tax assets, and actuarial assumptions used in determining pension and other postretirement benefit costs.

Income Tax Accruals

The Internal Revenue Service has recently increased its focus on auditing the adequacy of companies' income tax accruals. The IRS audit manual states that in unusual circumstances, the examiner may have access to auditors' audit working papers (or CPA firms' tax workpapers) if it is unsuccessful in obtaining that information from the company itself. As a result of clients' concerns about IRS access to information about income tax accruals, some clients might desire to limit their auditors' access to that information, hoping to preclude IRS examiners from obtaining tax information from the auditors. For example, clients may (a) deny the auditors access to documentation supporting accrued income taxes recorded in the financial statements, (b) not prepare or maintain adequate documentation of income tax accruals, or (c) deny the auditor access to the client's employees that are responsible for estimating the amount of income taxes recorded in the financial statements.

Auditors are required to obtain sufficient appropriate audit evidence about material assertions in the financial statements or else issue a qualified opinion or disclaim an opinion on the financial statements. Thus, if a client does not have documentation supporting the income tax accruals recorded in the financial statements and the related disclosures or denies auditors access to that documentation or to client personnel responsible for preparing such information or making income tax estimates, auditors generally would be precluded from issuing an unqualified opinion. In those circumstances, generally auditors should disclaim an opinion on the financial statements because the client has imposed the restrictions on the auditors' ability to form an opinion. (See AU 508.24.)

Some clients may attempt to limit auditors' access to information about tax accrual matters by (a) furnishing such information to its outside legal counsel or in-house legal or tax counsel and asking counsel to provide the auditors with an opinion on the adequacy of the income tax accrual or (b) obtaining the advice or opinion of an outside tax adviser related to tax accrual matters and limiting the auditors' access to, or documentation of, the opinion of the outside adviser. The auditing interpretation at AU 9326.17–.19 states that neither outside nor in-house legal or tax counsel are considered as *specialists* within the meaning of AU section 336, *Using the Work of a Specialist*. Thus, while opinions of outside or in-house legal counsel can be useful to auditors in forming their opinion on the financial statements, auditors cannot rely solely on the opinions of legal counsel to support their opinion on the financial statements. Similarly, auditors cannot rely solely on the advice or opinion of an outside tax adviser (notwithstanding client concerns regarding attorney-client or other forms of privilege). In both circumstances, auditors should evaluate whether the opinions of legal counsel or tax advisors support the amounts and disclosures in the financial statements using their tax expertise and knowledge of the client's business accumulated during all aspects of the audit. If they are unable to satisfy themselves about amounts and disclosures in the financial statements, the auditors should modify their report for the scope limitation.

Whenever clients limit or deny auditors access to information, best practices indicate that auditors should consider whether there are implications regarding management integrity and whether it might indicate the possible existence of fraud. In those circumstances, the auditors might consider withdrawing from the engagement and consulting with their legal counsel.

Guarantees

FASB Interpretation (FIN) No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," (FASB ASC 460-10-25-4 and 460-10-30-2) clarifies that at the time a company issues a guarantee included in the scope of this guidance (FASB ASC 460), the company must recognize an initial liability for the fair market value of the obligation it assumes under the guarantee including the liability to stand ready to perform under the terms of the guarantee. Prior to this guidance (FASB ASC 460), many companies followed the practice of recording a liability only when a loss under a guarantee was probable and reasonably estimable. It might be difficult for some companies to estimate the initial and subsequent fair value of the liability to record, since generally the guarantees are not readily marketable. Auditors should not conclude, however, that a difficulty in estimating the amount to record in the financial statements constitutes a limitation on the scope of their audit. When amounts required by GAAP to be recorded in financial statements are omitted and such amounts are material, including when the amounts are not reasonably determinable, auditors should modify their report for a departure from GAAP.

Fraud or Illegal Acts

Auditors may conclude that a modified report for a scope limitation is appropriate when they have determined that fraud or illegal acts may exist.

Client-imposed Restrictions on Scope of Services

If a client attempts to restrict the scope of the audit indirectly, for example through fee constraints or deadlines, auditors should consider whether there are valid business reasons for the restrictions or whether those reasons are the result of a desire to limit the auditors' access to information they may need to perform the audit. If the auditors conclude that there are valid business reasons underlying the restrictions, it is believed that the auditors should still disclaim an opinion on the financial statements because the client has imposed the restrictions on the auditors' ability to form an opinion. If, on the other hand, the auditors believe that the restrictions are an attempt by the client to limit or deny the auditors access to information, best practices indicate that the auditors should consider whether there are implications regarding management integrity and whether it might indicate the possible existence of fraud. In those circumstances, generally the auditors should consider withdrawing from the engagement and should also consult with their legal counsel.

Variable Interest Entities

FASB Interpretation No. (FIN) 46(R), "Consolidation of Variable Interest Entities," (FASB ASC 810) addresses the appropriate consolidation of entities commonly referred to as special purpose or variable interest entities. Such entities are often created to carry out a specified purpose or activity. In a variable interest entity (VIE), control is achieved through variable interests rather than through voting interests. FIN 46 (FASB ASC 810) generally requires consolidation of entities that are controlled other than through a majority voting interest.

Some auditors have questioned whether auditors' reports that are qualified for a scope limitation would become more prevalent after the issuance of FIN 46(R) (FASB ASC 810) because of a concern that some small and mid-size companies would not be able to obtain the information necessary to determine whether and how the guidance applies. However, FIN 46, paragraph 4, (FASB ASC 810-10-15-17) exempts from its requirements a company with an interest in a VIE (or a potential VIE) created before December 31, 2003, that, after making an exhaustive effort, is unable to obtain the information necessary to—

a. Determine whether the entity in which it has a variable interest is a VIE,

b. Determine whether it is the primary beneficiary of that entity, or

c. Perform the accounting required to consolidate a VIE.

The inability to obtain that information establishes a presumption that the reporting entity does not control the entity in which it has a variable interest. Note, however, that FIN 46 (FASB ASC 810-10-15-17) requires an exhaustive effort to first be made before the exception applies. (In addition, certain disclosures are required when the exception applies; it is permitted only as long as the reporting entity is unable to obtain the necessary information; and transition guidance is provided for entities that are subsequently able to obtain the information.) Thus, paragraph 4 of FIN 46 (FASB ASC 810-10-15-17) addresses an exemption from the requirement to consolidate VIEs rather than a limitation on the scope of the auditor's procedures. Assuming the entity meets the requirements of paragraph 4 of FIN 46 (FASB ASC 810-10-15-17) and makes the required disclosures, the financial statements of the entity are in conformity with GAAP, and best practices indicate it will be unlikely that auditors will need to qualify their report for a scope limitation.

If entities are not exempt from the requirement to consolidate VIEs as explained in the preceding paragraph, auditors should determine whether they are able to obtain sufficient appropriate audit evidence with respect to VIEs and related transactions to provide reasonable assurance that the financial statements are free of material misstatement. If auditors are unable to obtain sufficient appropriate audit evidence, they should consider modifying their report for the scope limitation. Because of the complexity of FIN 46 (FASB ASC 810) and the potential for the consolidation of entities not historically included in a reporting entity's financial statements, it is understood that some reporting entities are instructing their auditors to ignore or disregard the requirements to consolidate VIEs and to modify the auditor's report as appropriate. In that situation, it is believed that the scope limitation is imposed by the client, and, the auditors should disclaim an opinion on the financial statements. Since a determination has not been made about whether FIN 46 (FASB ASC 810) requires consolidation or disclosure, modifying the auditor's report for a departure from GAAP is not appropriate.

Uncertain Tax Positions

Depending on the facts and circumstances, there may be varying views on the appropriate income tax treatment of a transaction. Therefore, there may be uncertainty about whether a tax position would be sustained by the taxing authority in the event it examined the position. FASB Interpretation No. (FIN) 48, "Accounting for Uncertainty in Income Taxes," (FASB ASC 740) clarifies that SFAS No. 5, *Accounting for Contingencies*, (FASB ASC 450) does not apply to accounting for uncertainty in income taxes. Instead, uncertain tax positions should be accounted for in accordance with the provisions of FIN 48, (FASB ASC 740) which prescribes a recognition threshold (more likely than not) for recording a tax position in financial statements and, for those tax positions for which there is greater than a 50% chance of being sustained, prescribes how the tax positions should be measured.

FIN 48 (FASB ASC 740) has potential far-reaching implications because it requires entities to evaluate all material tax positions—claimed and unclaimed—in every jurisdiction, for every taxing authority and for every open tax year to determine whether the tax benefit that is or will be derived from the tax position should be recognized in the financial statements and, if so, at what amount. The reporting entity is required to consider whether there is greater than a 50% chance that each material tax position will be sustained. In determining whether a tax position has greater than a 50% chance of being sustained upon examination, an entity must assume that the tax return for the year in which the position is taken will be examined and that the position will also be examined. Nevertheless, in some cases, assessing the likelihood that a tax position will be sustained may be relatively straightforward. For example, the tax positions of many small and midsize nonpublic entities are likely to be based on clear and unambiguous tax law and, thus, have far greater than a 50% chance of being sustained upon examination.

In other cases, however, deciding which tax positions to recognize in the financial statements (that is, which tax positions have greater than a 50% likelihood of being sustained upon examination) will not be as clear-cut. For example, greater uncertainty may exist in assessing state and local income tax positions because of nexus issues. In addition, because of the tax expertise that may be required in some cases to make the assessment of tax positions and the additional time and cost that may be required, some entities may decide it is not cost beneficial to do so for all material tax positions. For example, an entity may decide it is not cost beneficial to evaluate whether it has nexus in all of the states in which it does business or whether it is more likely than not that a tax liability exists for the open tax years in those jurisdictions.

Auditor's Communication with Those Charged with Governance Is Not Adequate

SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AU 380), establishes requirements for auditors to communicate certain matters to those charged with governance and provides guidance on the auditor's communication. The primary purposes of communication with those charged with governance are to (a) clearly communicate an overview of the audit scope, the timing of the audit, and the auditor's responsibilities; (b) provide timely observations arising from the audit that are relevant to oversight of the financial reporting process; and (c) obtain relevant audit-related information from those charged with governance.

SAS No. 114 (AU 380) addresses two-way communication—communication from those charged with governance as well as the auditor's communication to those charged with governance. Effective two-way communication assists both the auditor and those charged with governance to understand matters related to the audit and develop a constructive working relationship. It also enables those charged with governance to fulfill their responsibility to oversee the financial reporting process. Furthermore, the auditor may be able to obtain important information from those charged with governance that is relevant to understanding the client and its environment, identifying sources of audit evidence, and obtaining information about specific events and transactions.

As part of the auditor's responsibilities under SAS No. 114, (AU 380) auditors are required to evaluate whether the communication between the auditor and those charged with governance has been adequate. If, in the auditor's judgment, the communication with those charged with governance was not adequate, it may indicate that the auditor has not obtained sufficient appropriate evidence to form an opinion on the financial statements. In those circumstances, the auditor should take appropriate action to address the effectiveness of the communication process. Also, the auditor should consider the effect, if any, on the assessment of the risks of material misstatement and may want to discuss the situation with those charged with governance. If the situation cannot be resolved, the auditor may take other actions, including the following:

- Modifying the opinion to reflect a scope limitation.
- Obtaining legal advice about the consequences of different actions.
- Communicating with third parties.
- Withdrawing from the engagement.

KNOWING WHEN TO WITHDRAW FROM THE ENGAGEMENT

Statement on Quality Control Standards (SQCS) No. 7, *A Firm's System of Quality Control* (QC 10), requires firms to establish policies and procedures for the acceptance and continuance of client relationships and specific engagements. If the firm obtains information that would have caused it to decline an engagement if that information had been available earlier, policies and procedures on the continuance of the engagement and the client relationship should include consideration of the professional and legal responsibilities that apply to the circumstances, and the possibility of withdrawing from the engagement or from both the engagement and the client relationship. Paragraph 35 of SQCS No. 7 (QC 10.35) states that firms' policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship should include documenting significant issues, consultations, conclusions, and the basis for the conclusions. Those procedures may include the following:

- Discussing with the appropriate level of the client's management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances.
- Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
- If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship.

Auditors may discover during the course of an audit that they are faced with a scope limitation that causes them to consider withdrawing from the engagement. Examples of those situations include detecting fraud or illegal acts, determining that unaudited financial statements presented with audited financial statements contain a departure from GAAP, finding that a company's records are unauditable, and being denied access to information the auditors need to perform the audit.

Fraud or Illegal Acts

Fraud. SAS No. 99 (AU 316), *Consideration of Fraud in a Financial Statement Audit*, provides guidance on the auditor's responsibility to identify and assess the risk of material misstatement due to fraud and to design the audit to provide reasonable assurance of detecting fraud that results in the financial statements being materially misstated. If the auditors determine there is evidence that fraud may exist (even if the matter is inconsequential), AU 316.79 requires the auditors to report it to the appropriate level of management and consider the implications for other aspects of the audit.

AU 316 notes that if auditors have determined that misstatements are or may be the result of fraud *but have also determined that (a) the effect on the financial statements could not be material and (b) the organizational position of those involved in the fraud does not have further audit implications* (for example, fraud involving misappropriation of cash from a small petty cash fund by a nonmanagement employee), the auditors should refer the matter to an appropriate level of management. Such circumstances, however, do not affect their ability to issue an unqualified opinion on the financial statements.

AU 316 does not include guidance on when auditors should express a qualified, adverse, or disclaimer of opinion resulting from misstatements that are, or may be, the result of fraud. Instead, it refers auditors to SAS No. 58 (AU 508) for guidance on when to modify the auditor's report. For example—

a. A scope limitation might result if auditors are denied access to information related to the fraud.

b. A scope limitation might result if evidence supporting account balances and transactions has been destroyed.

c. A GAAP departure might result if the financial statements are misstated as a result of fraud.

Whenever auditors conclude that the possibility of fraud exists, best practices indicate they should consider consulting with legal counsel. If the auditors issue a modified report on the financial statements in those circumstances, it is believed the explanatory paragraph of their report should describe the effects or possible effects on the financial statements but should not use the term *fraud* or similar terms since the determination of fraud is a legal matter.

AU 316 also notes, however, that the auditors' consideration of risk and the results of audit procedures may indicate that the risk of fraud is significant enough that the auditors should consider withdrawing from the engagement and communicating the reasons why they are withdrawing to those charged with governance (or the owner/manager). This may occur, for example, if the auditors conclude that it is not practicable to modify planned audit procedures sufficiently to address the risk. In addition, AU 316 notes that the auditors should consider the diligence and cooperation of management and the board of directors in investigating the circumstances and taking remedial action.

Illegal Acts. When auditors become aware of illegal acts (that is, violations of laws or governmental regulations), they should communicate their findings to those charged with governance (or owner/manager), unless the matters are clearly inconsequential. [Auditors may agree with those charged with governance (or owner/manager) in advance about the nature of matters that will be communicated.] Material illegal acts affect the auditors' report in the same manner as fraud. Accordingly, SAS No. 54 at AU 317.18–.20 notes that auditors should take the following action:

- If the auditors conclude that an illegal act has a material effect on the financial statements and the financial statements have not been revised, they should issue a qualified or adverse opinion on the financial statements.
- If the company precludes the auditors from obtaining sufficient appropriate audit evidence to evaluate whether a material illegal act has, or is likely to have, occurred, the auditors generally should disclaim an opinion on the financial statements.
- If the company refuses to accept the auditors' modified report, the auditors should withdraw from the engagement, indicating their reasons to those charged with governance (or owner/manager).

According to SAS No. 54 at AU 317.22, auditors also should consider withdrawing from the engagement when the company does not take remedial action that the auditors consider necessary, even if the illegal act is not material to the financial statements.

AU 317 also states that if auditors are unable to determine whether an act is illegal because of limitations imposed by the circumstances rather than by the company or because of uncertainty associated with interpretation of relevant laws or regulations or the surrounding facts, they should consider the effect on the auditor's report.

Auditors' Request to Extend Scope of Audit. Auditors may request permission to extend their testing because certain preliminary test results have indicated that a company's internal control was inadequate and that defalcations have occurred. If the auditors' request to extend the scope of their audit is denied, it is believed that a disclaimer of opinion because of a scope limitation would be inappropriate since the auditors have information indicating that financial statements prepared from the company's accounting records may not be fairly presented in conformity with GAAP. In those circumstances, it is recommended that the auditors should withdraw from the engagement.

Unaudited Financial Statements Not in Conformity with GAAP

Auditors also should consider withdrawing from the engagement when they determine that unaudited financial statements that are presented with audited financial statements contain a departure from GAAP. In those situations, SAS No. 26 at AU 504.13, *Association With Financial Statements*, states:

> If the client will not agree to revision of the financial statements or will not accept the accountant's disclaimer of opinion with the description of the departure from generally accepted accounting principles, the accountant should refuse to be associated with the statements and, if necessary, withdraw from the engagement.

Unauditable Records

Auditors also might withdraw from an engagement when they find that the company's records are insufficient to allow them to apply generally accepted auditing standards. That situation is most likely to be encountered in an initial audit of previously unaudited financial statements. Auditors might conclude at an early stage of such an audit that a disclaimer because of a scope limitation seems inevitable. In those cases, the auditors might best serve the client by suggesting withdrawal rather than incurring audit costs that will only result in a disclaimer of opinion. The auditors should offer guidance to the company about establishing reliable accounting records so that future years' financial statements may be audited.

Denial of Access to Information

Whenever clients limit or deny auditors access to information, best practices indicate that auditors should consider whether that circumstance has implications regarding management integrity and whether it might indicate the possible existence of fraud. Generally, since the restriction on the scope of the audit emanates from the highest levels of management, best practices indicate that the auditors should consider withdrawing from the engagement and should also consult with their legal counsel.

Inadequate Communication with Those Charged with Governance

An auditor's response when communication with those charged with governance has not been adequate and that situation cannot be resolved includes consideration of withdrawing from the engagement.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

12. When a company refuses to furnish written representations the auditor considers necessary, the auditor should consider how such refusal affects his or her ability to rely on which of the following?

    a. Only other written representations.

    b. Both other written and oral representations.

13. An auditor's inability to perform procedures he or she considers necessary concerning a material matter constitutes a scope limitation, and causes the auditor to:

    a. Qualify his or her opinion.

    b. Withdraw from the audit.

14. All of the following statements regarding management's representation letter are correct **except**:

    a. It should be dated as of the date of the auditor's report on the financial statements.

    b. On or before the date of the auditor's report, management should confirm that they will sign the letter.

    c. Management must deliver its letter to the auditor no later than the date of the auditor's report.

    d. The auditor needs the signed management representation letter prior to releasing the auditor's report.

15. Lack of adequate records supporting the opening balance of a balance sheet account for prior years may require certain actions by auditors. Which of the following actions would **not** be appropriate?

    a. Express a qualified opinion.

    b. Disclaim an opinion.

    c. Withdraw from the engagement.

16. Auditors should consult __________ for guidance on when to use the work of a specialist and how to determine whether the specialist's findings support the related assertions in the financial statements.

    a. SAS No. 67.

    b. SAS No. 70.

    c. SAS No. 73.

    d. SAS No. 85.

17. A GAAP departure might result if which of the following occurs?

    a. Financial statements are misstated as a result of fraud.

    b. Auditors are denied access to information related to fraud.

    c. Evidence supporting account balances and transactions has been destroyed.

18. Pursuant to SAS No. 54, in which of the following situations should auditors consider withdrawing from the engagement?

    a. The illegal act is not material to the financial statements and the company does not take remedial action that the auditors consider necessary.

    b. The auditors conclude that an illegal act has a material effect on the financial statements and the financial statements have not been revised.

    c. The company prevents the auditors from obtaining sufficient appropriate audit evidence to evaluate whether a material illegal act has, or may have, occurred.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

12. When a company refuses to furnish written representations the auditor considers necessary, the auditor should consider how such refusal affects his or her ability to rely on which of the following? **(Page 122)**

    a. Only other written representations. [This answer is incorrect. When a company refuses to furnish the auditor written representations that the auditor considers necessary, the auditor should consider how such refusal impacts his or her ability to rely on any other representation, not just written representations.]

    b. Both other written and oral representations. [This answer is correct. The auditor should consider how a company's refusal to furnish written representations the auditor considers necessary affects his or her ability to rely on any other representations, oral as well as written representations.]

13. An auditor's inability to perform procedures he or she considers necessary concerning a material matter constitutes a scope limitation, and causes the auditor to: **(Page 122)**

    a. Qualify his or her opinion. [This answer is correct. If an auditor cannot perform procedures he or she considers necessary regarding a material matter, a scope limitation is the result and the auditor must qualify his or her opinion or disclaim an opinion.]

    b. Withdraw from the audit. [This answer is incorrect. It is not necessary for the auditor to withdraw from the audit due to his or her inability to perform procedures that are considered necessary regarding a material matter. The auditor simply needs to qualify their opinion or disclaim an opinion.]

14. All of the following statements regarding management's representation letter are correct **except**: **(Page 122)**

    a. It should be dated as of the date of the auditor's report on the financial statements. [This answer is incorrect. Management's representation letter should always be dated as of the date of the auditor's report on the financial statements so the auditor knows that he or she can issue the auditor's report without scope limitations.]

    b. On or before the date of the auditor's report, management should confirm that they will sign the letter. [This answer is incorrect. Management should confirm to the auditor on or before the date of the auditor's report that they will have reviewed the final representation letter and confirmed they will sign the letter because management's refusal to furnish written representations constitutes a limitation on the scope of the audit.]

    c. Management must deliver its letter to the auditor no later than the date of the auditor's report. [This answer is correct. Management does not need to physically provide its representation letter to the auditor on the date of the auditor's report, just its intent to do so. The letter must be to the auditor prior to releasing the report.]

    d. The auditor needs the signed management representation letter prior to releasing the auditor's report. [This answer is incorrect. The auditor needs the signed management representation letter prior to releasing the auditor's report because management's refusal to furnish written representations constitutes a limitation on the scope of the audit that could preclude an unqualified opinion.]

15. Lack of adequate records supporting the opening balance of a balance sheet account for prior years may require certain actions by auditors. Which of the following actions would **not** be appropriate? **(Page 123)**

    a. Express a qualified opinion. [This answer is incorrect. Depending on the circumstances, lack of adequate records supporting the opening balance of a balance sheet account for prior years may require the auditors to express a qualified opinion because inadequate accounting records for the prior year generally would prelude auditors from determining that GAAP has been consistently applied.]

    b. Disclaim an opinion. [This answer is incorrect. A disclaimer on the current year's income statement or the statement of cash flows may be required if adequate records supporting the opening balance of a balance sheet account for prior years are not available.]

    c. Withdraw from the engagement. [This answer is correct. Withdrawing from the engagement by the auditors would not be required due to inadequate records for prior years. If current-year records are inadequate, the auditors might consider withdrawing from the engagement.]

16. Auditors should consult _________ for guidance on when to use the work of a specialist and how to determine whether the specialist's findings support the related assertions in the financial statements. **(Page 125)**

    a. SAS No. 67. [This answer is incorrect. SAS No. 67, *The Confirmation Process,* defines accounts receivable.]

    b. SAS No. 70. [This answer is incorrect. SAS No. 70, *Service Organizations,* recognizes that an entity may use a service organization to provide services that are part of the entity's information system.]

    c. SAS No. 73. [This answer is correct. SAS No. 73, *Using the Work of a Specialist,* discusses situations where auditors may use the work of a specialist and procedures to apply to determine whether the specialist's findings support the related assertions in the financial statements.]

    d. SAS No. 85. [This answer is incorrect. SAS No. 85, *Management Representation Letters,* addresses various aspects of written representations required as part of every engagement conducted in accordance with GAAS.]

17. A GAAP departure might result if which of the following occurs? **(Page 131)**

    a. Financial statements are misstated as a result of fraud. [This answer is correct. According to SAS No. 58, when financial statements are misstated as a result of fraud, a GAAP departure many times results.]

    b. Auditors are denied access to information related to fraud. [This answer is incorrect. If auditors are denied access to information related to fraud, a scope limitation might result per SAS No. 58.]

    c. Evidence supporting account balances and transactions has been destroyed. [This answer is incorrect. Per the guidance in SAS No. 58, if evidence supporting account balances and transactions has been destroyed, a scope limitation might result.]

18. Pursuant to SAS No. 54, in which of the following situations should auditors consider withdrawing from the engagement? **(Page 132)**

    a. The illegal act is not material to the financial statements and the company does not take remedial action that the auditors consider necessary. [This answer is correct. When the company does not take remedial action that the auditors consider necessary, even when the illegal act is not material to the financial statements, auditors should consider withdrawing from the engagement per SAS No. 54.]

    b. The auditors conclude that an illegal act has a material effect on the financial statements and the financial statements have not been revised. [This answer is incorrect. If the auditors conclude that an illegal act has a material effect on the financial statements and the financial statements have not been revised, they should issue a qualified or adverse opinion on the financial statements per SAS No. 54 at AU 317.18–.20.]

    c. The company prevents the auditors from obtaining sufficient appropriate audit evidence to evaluate whether a material illegal act has, or may have, occurred. [This answer is incorrect. If the company precludes the auditors from obtaining sufficient appropriate audit evidence to evaluate whether a material illegal act has, or may have, occurred, the auditors generally should disclaim an opinion on the financial statements per SAS No. 54 at AU 317.18–.20.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (GARTG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

8. When a scope limitation necessitates a qualified opinion, the situation must be described in a separate explanatory paragraph of the auditor's report preceding the opinion paragraph and referred to:

   a. In the scope paragraph of the report.

   b. In the opinion paragraph of the report.

   c. In both the scope and opinion paragraphs of the report.

   d. Do not select this answer choice.

9. If auditors have been engaged to audit the complete set of financial statements, but conditions prevent them from expressing an opinion on one or more of the basic financial statements:

   a. They should disclaim an opinion on the financial statements they did not audit and express an opinion on the balance sheet only.

   b. They must modify their report for a scope limitation.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

10. Sometimes a scope limitation prevents auditors from confirming accounts receivable. If receivables are not confirmed due to restrictions imposed by the company, and receivables are material, the auditors should:

    a. Qualify their opinion on the financial statements.

    b. Disclaim an opinion on the financial statements.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

11. If it is not possible to observe the taking of physical inventory at the beginning of the period, the auditor is taking the correct action under which of the following scenarios?

    a. In cases where auditors review the inventory observation work of the other auditors, the auditor should always issue a qualified opinion.

    b. If the company's financial statements for the prior year were not audited, the auditor must disclaim an opinion on all of the financial statements.

    c. In first audits, the auditors may express an opinion on the balance sheet only, and may either qualify their opinion or disclaim an opinion on the income statement and statement of cash flows.

    d. Do not select this answer choice.

12. Which of the following procedures would cause auditors to express an opinion that is modified for a scope limitation on the financial statements?

    a. Successor auditors' evaluation of certain communications with predecessor auditors.

    b. Information obtained by auditors from management regarding litigation, claims, and assessments.

    c. Verbal representations from management obtained by auditors.

    d. Procedures to identify related party relationships and transactions.

13. Auditors are required to obtain certain written representations from the company being audited as part of every engagement conducted in accordance with GAAS. Furthermore, if comparative financial statements are presented, representations should cover:

    a. The most recent audit period.

    b. The current and one prior audit period.

    c. The current and two prior audit periods.

    d. All periods covered by the audit.

14. When management refuses to sign a management representation letter, which of the following statements is correct?

    a. A compilation report can be substituted for a qualified opinion.

    b. A compilation report can be substituted for a disclaimer of opinion.

    c. A review report can be substituted for a qualified opinion.

    d. A compilation or a review report cannot be substituted for a qualified opinion or a disclaimer of opinion.

15. Which of the following actions by the client's lawyer would constitute a limitation on the scope of the audit?

    a. Refusing to furnish written or oral information requested by the auditor in a letter of inquiry.

    b. Limiting their response to matters they have given substantive attention to in the form of legal consultation or representation.

    c. Limiting their responses to matters considered to be material to the financial statements.

    d. Inability to give an unequivocal evaluation of the likelihood that litigation will be resolved unfavorably.

16. Generally, whenever clients limit auditors' access to information and issues of integrity or fraud are suspected, auditors should:

    a. Modify their report to indicate access to information was limited or denied.

    b. Disclaim an opinion on the financial statements because of a scope limitation.

    c. Express an unqualified opinion based on the information provided by the client.

    d. Consider withdrawing from the engagement and consult with legal counsel.

17. FASB Interpretation No. (FIN) 48 requires reporting entities to evaluate all material tax positions and to consider whether there is __________ chance that each material tax position will be sustained.

    a. Greater than a 30%.

    b. Greater than a 40%.

    c. Greater than a 50%.

    d. Greater than a 75%.

18. Material illegal acts must affect the auditors' report. According to SAS No. 54, if the company refuses to accept the auditors' modified report, the auditors should take which of the following actions?

    a. Withdraw from the engagement.

    b. Issue a qualified or adverse opinion on the financial statements.

    c. Disclaim an opinion on the financial statements.

    d. Do not select this answer choice.

Lesson 3: Other Report Modifications

INTRODUCTION

SAS No. 58 (AU 508) requires auditors to add or consider adding an explanatory paragraph (or other explanatory language) to their report in the following circumstances although they express an unqualified opinion on the financial statements:

- There has been a material change between periods in accounting principles or in the method of applying them.
- The financial statements are affected by uncertainties about the entity's ability to continue as a going concern.
- Certain circumstances relating to reports on comparative financial statements exist.
- The auditor's opinion is based in part on the report of another auditor.
- Certain circumstances relating to information presented outside of the basic financial statements exist.
- To prevent the financial statements from being misleading because of unusual circumstances, the financial statements contain a departure from an established accounting principle.

In addition, SAS No. 58 at AU 508.11 permits auditors to add an explanatory paragraph to their report to emphasize a matter regarding the financial statements. This lesson discusses "emphasis of a matter" (EOM) paragraphs and the following circumstances, which also require auditors to modify the standard report:

- The financial statements include a correction of an error not involving accounting principles.
- The auditors are requested to issue an opinion on one of the basic financial statements and to disclaim an opinion on the other basic financial statements.
- Unaudited financial statements are issued.
- The auditors are not independent.
- Financial statements are prepared in conformity with accounting principles generally accepted in another country.

This lesson also discusses reports that include more than one type of modification and piecemeal opinions.

Learning Objectives:

Completion of this lesson will enable you to:

- Summarize various aspects of emphasis-of-a-matter (EOM) paragraphs.
- Define modifications of the standard report including correction of an error, split-level reporting, and reports with more than one modification.
- Identify financial statements prepared in conformity with accounting principles generally accepted in another country.

UNDERSTANDING EMPHASIS OF A MATTER (EOM) PARAGRAPHS

Authoritative Literature

SAS No. 58 at AU 508.19 states:

> In any report on financial statements, the auditor may emphasize a matter regarding the financial statements. Such explanatory information should be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing [following] explanation" should not be used in the opinion paragraph if an emphasis paragraph is included in the auditor's report. Emphasis paragraphs are never required; they may be added solely at the auditor's discretion.

EOM Paragraphs Are Not Qualified Opinions

EOM paragraphs should not be confused with explanatory paragraphs that explain the substantive reasons for a qualified, adverse, or disclaimer of opinion. Furthermore, auditors should not use EOM paragraphs as a substitute for financial statement disclosures that are required by GAAP or to avoid qualifying their opinion for GAAP departures. Similarly, a paragraph that describes limitations on the scope of the audit does not affect the auditors' responsibility to express a qualified opinion or a disclaimer of opinion because of the scope limitation. Thus, when auditors' reports include EOM paragraphs, phrases such as "as explained in the preceding paragraph" should not be used in the opinion paragraph, because they may appear to qualify the auditors' opinion.

When to Use EOM Paragraphs

Many auditors believe that they may make whatever disclosures they deem appropriate in their report. Nevertheless, best practices that auditors avoid using EOM paragraphs whenever possible because they require the auditors to choose the information in the financial statements that should be emphasized. There is no authoritative criteria for deciding when to use an EOM paragraph because the presumption is that all disclosures required by GAAP are important. Thus, choosing one matter to discuss in an EOM paragraph could place undue emphasis on that matter and detract from other important disclosures. However, the auditors may decide that an EOM paragraph is necessary to highlight an unusual or important matter that is disclosed in the financial statements, such as an important subsequent event. Auditors traditionally have used EOM paragraphs to describe the following matters. (This list is not intended to be all-inclusive.)

- Pervasive related party transactions.
- The entity is a component of another entity, e.g., a subsidiary, branch, or affiliate. Generally a separate report for such an entity should disclose its component status, which may be done parenthetically in the introductory paragraph or in a separate EOM paragraph.
- Corrections of errors that do not involve accounting principles.
- An unusual or important subsequent event.
- The effect of an authoritative accounting standard prior to its effective date.
- The existence of significant uncertainties other than going concern uncertainties.
- The entity's current period financial statements on the liquidation basis of accounting are presented along with the entity's prior-period GAAP basis financial statements for a going concern. In those circumstances, the auditor's report may include an EOM paragraph that states the entity has changed the basis of accounting used to determine the amounts at which assets and liabilities are carried from the going concern basis to the liquidation basis.
- A change in accounting estimate that does not involve accounting principles, such as estimated useful lives or warranty costs.
- A reference to a separate qualified report on the financial statements of one of the entities included in consolidated financial statements when the effect is not material to the consolidated statements.

- The provisions of an unusually restrictive debt covenant.
- The company has a concentration in the volume of business transacted with another party, such as a major customer or supplier.
- A change in accounting principle that, although it is not material in the current year and therefore does not affect consistency, is expected to be material in future years.

Auditors also may find EOM paragraphs useful when the reporting entity is (a) dependent on federal cost reimbursement programs, e.g., nursing homes and low-income housing projects, (b) in an industry that is economically depressed, or (c) a development stage company. (Best practices indicate the auditor's report for a development stage company always should disclose that status, which may be done parenthetically in the introductory paragraph or in a separate EOM paragraph.) Auditors also may use an EOM paragraph to describe certain matters that they have considered in connection with their evaluation of the company's ability to continue as a going concern.

Related Party Transactions and Concentrations in Volume of Business

An EOM paragraph may be used to highlight significant related party transactions. However, an EOM paragraph is not appropriate when management has represented in the financial statements that related party transactions have been consummated on terms equivalent to *arm's-length transactions*, but is unable to substantiate that representation. If the auditors believe that management is unable to substantiate such a representation, SAS No. 45 at AU 334.12 states that they should consider qualifying their opinion or expressing an adverse opinion on the financial statements because of a departure from generally accepted accounting principles. It is believed that an EOM paragraph generally should be used only when pervasive related party transactions occur and the company's treatment of the transactions, including related disclosure, does not cause the auditors to modify their opinion on the financial statements. An example of an EOM paragraph for related party transactions follows.

> As discussed in Note X to the financial statements, certain officers of the Company own a building, a portion of which is leased by a division of the Company at an annual fee of $50,000 plus a pro rata share of taxes, insurance, and other operating costs.

The definition of a related party in SFAS No. 57 (FASB ASC 850-20) does not include a company that is economically dependent on one or more parties with which it transacts a significant volume of business, such as a sole or major customer, supplier, franchisor, franchisee, distributor, general agent, borrower, or lender. Those parties should not be considered to be related parties solely by virtue of economic dependency unless one of them clearly exercises significant management or ownership influence over the other. SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (FASB ASC 275-10-50-16 through 50-22), requires disclosure of concentrations in the volume of business transacted with a particular customer, supplier, or lender if the concentrations meet certain criteria. Auditors also may wish to highlight certain concentrations in an EOM paragraph of their report. An example of such an illustration follows.

> As discussed in Note X to the financial statements, a significant part of the Company's business is dependent on a few customers, and the loss of any one could have a materially adverse effect on the Company. Five customers accounted for approximately 90% of the revenues reported for the year ended December 31, 20X1. There are no formal contracts to continue business with those customers.

Subsequent Events

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events* (FASB ASC 855-10) to establish requirements for the accounting and disclosure of subsequent events. (This guidance is effective for periods ending after June 15, 2009, and should be applied prospectively.) While much of the guidance in AU 560 is carried forward, including the concept of type 1 and type 2 subsequent events, the new terms *recognized subsequent events* and *unrecognized subsequent events* are used which are defined as follows:

- *Recognized subsequent events*—events or transactions that provide evidence about conditions that existed at the balance sheet date, including the estimates inherent in the process of preparing financial statements.

- *Unrecognized subsequent events*—events that provide evidence about conditions that did not exist at the balance sheet date but arose after that date.

Recognized subsequent events should be recognized in the financial statements, but unrecognized subsequent events should not. For example, the bankruptcy of a major customer after the balance sheet date and the resulting uncollectibility of a material account receivable usually would require the financial statements to be adjusted before their issuance. Recognized subsequent events do not require financial statement disclosure simply because of their occurrence. However, other GAAP requirements may require the event to be disclosed.

Unrecognized subsequent events relate to conditions that did not exist at the balance sheet date being reported on and, accordingly, do not result in adjustments to the financial statements, e.g., the sale of a bond or capital stock issue, or the loss of plant or inventories as a result of fire or flood. However, unrecognized subsequent events require financial statement disclosure if they are of such a nature that disclosure is necessary to keep the financial statements from being misleading.

SFAS No. 165 (FASB ASC 855-10-25-2) also revises the guidance in AU 560 about the date through which subsequent events should be evaluated for potential recognition or disclosure. Public entities and other entities that expect to widely distribute their financial statements should evaluate subsequent events through the date that the financial statements are issued. Financial statements are considered issued when they are widely distributed to users in a form that complies with GAAP. Other entities, including nonpublic entities, should evaluate subsequent events until their financial statements are *available to be issued.* Financial statements are considered available to be issued when they are complete, in a form that complies with GAAP, and approved for issuance. SFAS No. 165 (FASB ASC 855-10-50-1) requires the financial statements to disclose the date through which subsequent events have been evaluated, as well as whether that date is the date the financial statement were issued or the date the financial statements were available to be issued.

Some auditors highlight the financial statement disclosure of unrecognized subsequent events with an EOM paragraph such as the following.

> As discussed in Note X to the financial statements, on March 19, 20X2, the Company entered into negotiations to sell a major division of its operations. The division represents a significant portion of the Company's total assets and operations.

An AICPA Technical Practice Aid at TIS 9070.05, *Consideration of Impact of Losses From Natural Disasters Occurring After Completion of Audit Field Work and Signing of the Auditor's Report But Before Issuance of the Auditors Report and Related Financial Statements*, states that a loss from a natural disaster occurring after an entity's year end is a type II (ie., unrecognized) subsequent event that would not result in adjustment of the financial statements, but disclosure of the event may be required to keep the financial statements from being misleading. (Occasionally, the event may be so significant that disclosure can best be made by supplementing the historical financial statements with pro forma financial data giving effect to the event as if it had occurred on the balance sheet date.) In those circumstances, the auditor may decide to include an emphasis of a matter paragraph in the auditor's report to highlight the event and its effects.

<u>Subsequent Events Consideration in the Current Economic and Financial Crisis.</u> An AICPA Technical Practice Aid at TIS 1100.15, Liquidity Restrictions, states that significant changes in fair value or changes in liquidity leading to violation of debt covenants that occur subsequent to the balance sheet date, but prior to the issuance of the financial statements "may need to be reflected in the financial statements (either through adjustment to or disclosure in the financial statements.)." Whether adjustment or disclosure is appropriate depends on whether the subsequent event was indicative of conditions that existed at the balance sheet date (adjustment) or arose after the balance sheet date (disclosure).

Accounting Standard Prior to Its Effective Date

An auditing interpretation at AU 9410.13, *The Impact on an Auditor's Report of an FASB Statement Prior to the Statement's Effective Date*, discusses the effect on the auditors' report when the financial statements on which the auditors are reporting will be revised in subsequent periods because a new accounting standard requires retrospective application of its provisions. Assuming the accounting principles currently being followed are acceptable, the interpretation states that the auditors should not qualify their opinion if a company does not adopt the accounting principles that will be prescribed by an accounting standard before its effective date. The interpretation states, however, that auditors should consider the potential effects of the change in evaluating whether disclosure of the impending change in accounting principle is essential for adequate disclosure. If the retrospective application will have a material effect on the financial statements, it is believed that it should be disclosed for the financial statements to be in conformity with GAAP. If the retrospective application is expected to materially affect the financial statements and the impending change is not disclosed, best practices indicate that the auditors should qualify their report for a departure from GAAP.

The interpretation also indicates that, even if the auditors believe that the impending change in accounting principle is adequately disclosed, they may emphasize the change in an EOM paragraph of their report. The interpretation at AU 9410.18 states:

> Even if the auditor decides that the disclosure of the forthcoming change and its effects are adequate and, consequently, decides not to qualify his opinion, he nevertheless may decide to include an explanatory paragraph in his report if the effects of the change are expected to be unusually material. The explanatory paragraph should not be construed as a qualification of the auditor's opinion; it is intended to highlight circumstances of particular importance and to aid in interpreting the financial statements.

Although the authoritative literature does not address whether disclosure should be considered if the change to the new accounting principle will be accounted for in the financial statements of future periods (for example, prospectively), best practices indicate that the financial statements disclose a brief description of the new accounting principles and their effective date.

An illustration of a paragraph emphasizing the future effect of an accounting change follows.

> As discussed in Note X, the Financial Accounting Standards Board recently issued revised accounting standards related to *Accounting for Defined Benefit Pension and Other Postretirement Plans*. The new standards require employers to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. It defines the funded status of a defined benefit pension plan as the difference between the fair value of the plan assets and the projected benefit obligation. Previously unrecognized items, such as gains or losses, prior service credits, and transition assets or liabilities, will be recognized in other comprehensive income and will be subsequently recognized through net periodic benefit cost. The Company is currently evaluating the effect of adopting the new accounting standards but expects that it will not have a material adverse effect on its consolidated financial position for the year ended June 30, 20XX.

Uncertainties

Auditors are not required to include an explanatory paragraph in their report for uncertainties other than going concern uncertainties. Although it is recommended that auditors avoid using EOM paragraphs whenever possible because they require the auditors to choose the information in the financial statements that should be emphasized, some auditors may choose to highlight uncertainties relating to the future outcome of exceptional litigation or regulatory action in an EOM paragraph of their report. An example of such an illustration follows.

> As discussed in Note X to the financial statements, the Company is a party to various legal and other actions. Those actions claim substantial damages as a result of alleged product defects and other matters. Management and legal counsel for the Company are of the opinion that the legal actions are without merit and that settlement of the actions will not have a material effect on the Company's financial position. Nevertheless, it is at least reasonably possible that such an effect will occur, although the amount cannot be estimated. Settlement of the legal actions is expected within the next year.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. Historically, auditors have used emphasis of a matter (EOM) paragraphs to describe which of the following matters?

    a. Corrections of errors involving accounting principles.

    b. Going concern uncertainties.

    c. Changes in accounting estimates not involving accounting principles.

    d. Changes in accounting principle not material or expected to be material in the future.

20. Which of the following would be categorized as unrecognized subsequent events?

    a. Events that did not exist at the balance sheet date being reported on.

    b. Events that affect the estimates inherent in the process of preparing financial statements.

    c. Events that do not require financial statement disclosure just because they occurred.

    d. Events that require financial statement adjustment because they are material.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. Historically, auditors have used emphasis of a matter (EOM) paragraphs to describe which of the following matters? **(Page 144)**

    a. Corrections of errors involving accounting principles. [This answer is incorrect. EOM paragraphs have traditionally been used to describe corrections of errors that do *not* involve accounting principles. This is done to highlight an important mater.]

    b. Going concern uncertainties. [This answer is incorrect. Auditors have found using EOM paragraphs to describe the existence of significant uncertainties *other than* going concern uncertainties has been necessary to highlight this matter.]

    c. Changes in accounting estimates not involving accounting principles. [This answer is correct. Auditors have used EOM paragraphs to describe changes in accounting estimates that do no involve accounting principles, such as estimated useful lives or warranty costs.]

    d. Changes in accounting principle not material or expected to be material in the future. [This answer is incorrect. Changes in accounting principles that, although not material in the current year and therefore do not affect consistency, but are expected to be material in future years have been highlighted by auditors by using EOM paragraphs.]

20. Which of the following would be categorized as unrecognized subsequent events? **(Page 146)**

    a. Events that did not exist at the balance sheet date being reported on. [This answer is correct. Per SFAS No. 165, events that did not exist at the balance sheet date being reported on would be categorized as unrecognized subsequent events such as the sale of a bond or capital stock issue, the loss of plant or inventories as a result of fire or flood, or the purchase of a business. These events do not result in adjustments to the financial statements.]

    b. Events that affect the estimates inherent in the process of preparing financial statements. [This answer is incorrect. Events that result in adjustments to the financial statements are categorized as recognized subsequent events per SFAS No. 165.]

    c. Events that do not require financial statement disclosure just because they occurred. [This answer is incorrect. According to the guidance in SFAS No. 165, recognized subsequent events include events that do not require financial statement disclosure simply because they occurred.]

    d. Events that require financial statement adjustment because they are material. [This answer is incorrect. According to the guidance in SFAS No. 165, recognized subsequent events, if material, do require adjustment of the financial statements.]

DEALING WITH CORRECTION OF AN ERROR

Authoritative Literature

SAS No. 107 (AU 312.09) states that the term *errors* refers to unintentional misstatements of amounts or disclosures in financial statements. Errors may include:

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

b. Unreasonable accounting estimates arising from oversight or misinterpretation of facts.

c. Mistakes in the application of accounting principles relating to amount, classification, manner of presentation, or disclosure.

Errors can cause financial statements to be materially misstated.

When auditors discover a material error in financial statements on which they have previously reported, SAS No. 1 at AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, applies. Among other actions, it requires the financial statements and the auditor's report to be revised as soon as practicable. AU 561.06 provides the following guidance, in part, when auditors discover a material error in previously issued financial statements and they believe persons are still relying on the statements:

a. If the effect on the financial statements or auditor's report of the subsequently discovered information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report. The reasons for the revision usually should be described in a note to the financial statements and referred to in the auditor's report. Generally, only the most recently issued audited financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.

b. When issuance of financial statements accompanied by the auditor's report for a subsequent period is imminent, so that disclosure is not delayed, appropriate disclosure of the revision can be made in such statements instead of reissuing the earlier statements pursuant to subparagraph (a).

As indicated in the preceding paragraph, if revised financial statements are reissued, the auditors should determine that the reasons for the revision are described in the notes to the financial statements and should refer to the reasons for the revision in their revised report.

Errors that involve accounting principles (item c. above) affect the consistency standard. Thus, according to SAS No. 58 (AU 508), if the financial statements are revised for the correction of an error that involves accounting principles, the auditors should issue an unqualified opinion on the revised financial statements and should describe the errors in an explanatory paragraph following the opinion paragraph of their report. On the other hand, if the financial statements are revised for the correction of an error that does *not* involve accounting principles (items a. and b. above), the consistency standard is not affected. Although AU 561.06(a) requires the auditors to describe the reasons for the revision in their report, the authoritative literature does not specify whether the explanatory paragraph should precede or follow the opinion paragraph. If the error does not involve accounting principles, disclosing the reasons for the revised financial statements in a separate paragraph following the opinion paragraph similar to the reporting for errors involving accounting principles is recommended.

In contrast, when the correction of an error is disclosed in the financial statements of the subsequent period, SAS No. 1 at AU 561.06(b) does not require the reasons for the revision to be disclosed in the auditor's report; they only need be disclosed in the notes to the financial statements. However, if the correction of the error involves accounting principles, SAS No. 58 (AU 508) still requires it to be disclosed in an explanatory paragraph following the opinion paragraph of the auditor's report. (Although not required, some auditors also may prefer to highlight the correction of an error *not* involving accounting principles in an explanatory paragraph of their report.)

PCAOB Auditing Standards No. 6, *Evaluating Consistency of Financial Statements*, requires auditors reporting on financial statements of public companies to modify their opinion if the comparability of the financial statements between periods is materially affected by adjustments to previously issued financial statements, even if the adjustment involves correction of errors not involving accounting principles. Even though PCAOB Auditing Standards apply only to audits of financial statements of issuers (i.e., public entities), if an audit firm audits both issuers and nonissuers, it may choose to establish a firm policy to include an explanatory paragraph in its audit reports on the financial statements of all clients when the financial statements reflect the correction of an error not involving accounting principles.

Report Illustration

An illustration of an additional paragraph that describes the correction of an error not involving an accounting principle follows. Auditors may include such a paragraph in their report when issuance of the financial statements of a subsequent period is imminent and only the financial statements for the subsequent period are presented.

> As discussed in Note X to the financial statements, certain errors resulting in overstatement of previously reported inventories as of December 31, 20X1, were discovered by management of the Company during the current year. Accordingly, the 20X1 financial statements have been restated [and an adjustment has been made to retained earnings as of January 1, 20X2] to correct the error.

The preceding paragraph would be modified by deleting the bracketed phrase if the revised financial statements are reissued or if the revised financial statements are not reissued but are presented in comparative form with the subsequent-period financial statements.

Dating of Reissued Report

AU 561.06 does not address the dating of the auditor's report on revised financial statements that are reissued to correct an error as described above in item a. It is believed that the auditors should follow the guidelines of SAS No. 1 at AU 530.06–.08 regarding dating a reissued report. That SAS allows the auditors to either dual date the report or use a later date (presumably the date of reissuance). It is believed dual dating is preferable to using a later date, because using a later date requires the auditors to extend their subsequent events review to the date of reissuance.

Proposed SAS, *Subsequent Events and Subsequently Discovered Facts*

In April 2009, the Auditing Standards Board issued an exposure draft, *Subsequent Events and Subsequently Discovered Facts,* that would, among other things, supersede the guidance in AU 561. The proposed SAS essentially retains the concepts in AU 561, but it is drafted from the perspective of the auditor's responsibility to inform management when the auditor becomes aware of subsequently discovered facts, and the auditor's responsibility based on management's response. If management revises the financial statements, the auditor should, depending on the circumstances—

> (a) issue a report with a different opinion from the previous report that includes an additional paragraph stating (i) the date of the previous report, (ii) the type of opinion previously expressed, (iii) the circumstances or events that caused the auditor to express a different opinion, and (iv) that the auditor's opinion on the revised financial statements is different from the auditor's previous opinion, or
>
> (b) dual date the report if the effect on the revision of the financial statements can be limited to disclosing the effects of the subsequently discovered facts in a note to the financial statements.

The proposed SAS does not specifically address the auditor's responsibility if management's disclosure of the subsequently discovered facts is made in the subsequent period's financial statements. However, the third standard of reporting states that when the auditor determines informative disclosures are not reasonably adequate, the auditor must state that in the auditor's report. Furthermore, if the revision of the subsequent period financial statements involves accounting principles, consistency is affected, and AU 508.16–.17 would require the auditor to add an explanatory paragraph following the opinion paragraph describing the change.

The proposed SAS also addresses a predecessor auditor's responsibilities when reissuing a previously issued audit report on financial statements of a prior period when they are to be presented on a comparative basis with audited financial statements of a subsequent period. That guidance currently is at AU 508.71–.73.

The comment period on the exposure draft ended July 15, 2009, and a final Statement is expected to be issued in the second quarter of 2010. The Statement would not be effective earlier than December 15, 2010.

SPLIT-LEVEL REPORTING ISSUES

What Is It?

The term *split-level reporting* refers to the expression of an audit opinion on one of the basic financial statements, e.g., the balance sheet, and a disclaimer of opinion on the other basic financial statement. Reporting in that manner occurs either because (a) the auditors only have been engaged to audit one basic financial statement, but the company wants to present a complete set of basic financial statements, or (b) the auditors have been engaged to report on a complete set of financial statements, but due to a scope limitation, are unable to render an audit opinion on all the financial statements. Generally the first situation is a "limited reporting engagement," and the second situation is a "scope limitation."

The report that is proper for a split-level reporting situation is controversial. With the issuance of SSARS No. 1 at AR 100, some accountants believe that it is appropriate for nonpublic companies to receive an audit opinion on the balance sheet and a review report on the statements of income, retained earnings, and cash flows. As discussed in the following paragraphs, best practices indicate reporting in that manner would be confusing to financial statement users and, thus, the auditors should generally issue a disclaimer of opinion on the financial statements they have not audited.

Authoritative Literature—Limited Reporting Engagement

Part of the confusion concerning the reporting issue described in the preceding paragraph is due to the scarcity of authoritative literature covering limited reporting engagements. SAS No. 58 at AU 508.33 acknowledges that limited reporting engagements are appropriate. That paragraph states:

> The auditor may be asked to report on one basic financial statement and not on the others. For example, he or she may be asked to report on the balance sheet and not on the statements of income, retained earnings or cash flows. These engagements do not involve scope limitations if the auditor's access to information underlying the basic financial statements is not limited and if the auditor applies all the procedures he or she considers necessary in the circumstances; rather, such engagements involve limited reporting objectives.

On *continuing* engagements, the use of compilation or review reports in "limited reporting engagements" is not recommended because:

a. It is sometimes difficult, if not impossible, to determine the difference between audit procedures and SSARS review procedures performed on the statements of income, retained earnings, and cash flows when both the opening and closing balance sheets have been audited. Accordingly, a consecutive series of audited balance sheets accompanied by other basic financial statements that have been reviewed is difficult to justify, especially if the additional work needed to express audit assurance on all the statements is minimal.

b. If the balance sheet is audited and the statement of income has been reviewed, it is difficult to determine the level of assurance that should be expressed on the statements of retained earnings and cash flows. On recurring engagements, a strong argument can be made that those statements would be audited. The resulting report would be very confusing.

c. It is questionable whether an auditor should express review assurance on a statement of income in cases involving client-imposed scope limitations that affect that statement.

On *initial* engagements, i.e., the first year that a company is audited, the auditor sometimes cannot express an opinion on the statements of income, retained earnings, and cash flows (for example, because he or she is unable to observe beginning inventory). The auditor may, however, be able to express an opinion on the balance sheet. In such a situation, is it permissible to audit the balance sheet and compile or review the statements of income, retained earnings, or cash flows? That approach to reporting is discouraged because it can lead to misuse, especially when the circumstances support a scope limitation.

Report Illustrations—Limited Reporting Engagement

When only the balance sheet has been audited but a complete set of financial statements is presented, the financial statements accompanying the balance sheet should be marked "unaudited," or otherwise clearly marked to distinguish them from the audited financial statement. It is recommended that the auditors issue a report similar to the following.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the accompanying balance sheet[a] of ABC Company (a Texas corporation) as of December 31, 20X1. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

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

Because we were not engaged to audit the statements of income, retained earnings, and cash flows, we did not extend our auditing procedures to enable us to express an opinion on results of operations and cash flows for the year ended December 31, 20X1.[b] Accordingly, we express no opinion on them.[c]

The balance sheet referred to in the first paragraph generally presents fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, in conformity with accounting principles generally accepted in the United States of America.[d]

Notes:

[a] Since the auditors were engaged to audit only the balance sheet, it is the only statement identified as being audited. *This form of report should not be used when the auditors are engaged to audit the complete set of financial statements but a scope limitation precludes the expression of an opinion on the financial statements that accompany the balance sheet.*

[b] The reasons for the auditors' disclaimer of opinion should be described in a separate paragraph of the report.

[c] The auditors should disclaim an opinion on the financial statements that they have not audited.

[d] This report assumes the auditors have been able to satisfy themselves regarding the consistency of application of accounting principles.

An interesting situation arises if, after issuing the report illustrated above (which includes a disclaimer on the statements of income, retained earnings, and cash flows because the auditors were not engaged to audit them), the auditors are subsequently engaged to audit those statements. Assume that the auditors are able to perform sufficient auditing procedures, including subsequent events procedures and auditing procedures on opening balance sheet accounts, to enable them to issue an unqualified opinion on the statements. The question is whether the new audit report on the complete set of financial statements (including the balance sheet) should refer to the previously issued disclaimer. Authoritative literature does not address this question. However, it is believed that the literature does not require the new report (which would carry a new date) to refer to the prior report that included a disclaimer. Thus, generally the appropriate report for the situation described would be the standard report for a single period.

The report to be issued in a limited reporting engagement assumes that the auditors have been able to satisfy themselves that accounting principles have been consistently applied. An illustration of a report in a limited reporting engagement when the auditors cannot express an opinion about consistency follows.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the accompanying balance sheet of ABC Company (a Texas corporation) as of December 31, 20X2. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

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

This was our first audit of the Company's balance sheet, and, in accordance with management's instructions, we did not extend our auditing procedures to enable us to express, and we do not express, an opinion on the consistency of application of accounting principles with the preceding year. Because we were not engaged to audit the statements of income, retained earnings, and cash flows, we did not extend our auditing procedures to enable us to express an opinion on results of operations and cash flows for the year ended December 31, 20X2. Accordingly, we express no opinion on them.

In our opinion, the balance sheet referred to in the first paragraph presents fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

The presentation of one financial statement or a complete set of financial statements in conformity with generally accepted accounting principles includes adequate disclosure of material matters. Those matters relate to the form, arrangement, and content of the financial statements and their appended notes. Accordingly, when only one financial statement is presented, auditors should consider whether any matters relating to the other financial statements that are pertinent to the financial statement presented also should be disclosed in light of the circumstances and facts of which they are aware at the time. If management omits such information from the financial statements, including the accompanying notes, the auditors should express a qualified or an adverse opinion and should, if practicable, provide the omitted information in their report.

Best practices indicate that the reporting approach illustrated and explained above be used in all limited reporting engagements. It is also recommended that the expression of an opinion on the balance sheet and the issuance of a review report on the statements of income, retained earnings, and cash flows be limited to situations when the complete financial statements have been reviewed in prior years, the company plans to engage the auditors to audit the financial statements in future years, and the split-level reporting is limited to the current year.

When the situation described above exists, generally it would be appropriate to issue a single report expressing an opinion on the audited balance sheet combined with a standard review report on the other statements. Although there is no authoritative literature specifically permitting such a report, neither is there any literature specifically prohibiting it. The most common approach to structuring such a report is to combine the language from the two types of reports. The first three paragraphs of the report would be a standard balance sheet only report on the audited statement. Immediately following those paragraphs would be the standard review report on the other financial statements. Auditors should use extreme caution when reporting on split-level engagements that include audits and reviews to properly distinguish the different levels of responsibility assumed for each of the various financial statements.

Authoritative Literature—Scope Limitation

When the scope of the audit permits the auditors to express an opinion on one basic financial statement but precludes the expression of an opinion on the others, the scope limitation (the procedures that the auditors omitted that caused the audit not to be in accordance with GAAS) should be described in a separate explanatory paragraph preceding the opinion paragraph, and referred to in both the scope and opinion paragraphs of the auditor's report. The procedures that the auditors applied, however, should not be described. Since the auditor has extended the auditing procedures to all of the basic financial statements, but the scope limitation precludes the expression of an opinion on one or more financial statements, it is not appropriate to issue a compilation or review report on the statements affected by the scope limitation.

Report Illustrations—Scope Limitations

An example of a report that includes a disclaimer on the statements of income, retained earnings, and cash flows because of a scope limitation as a result of an inability to observe opening inventory follows. AU 508.23 also permits issuance of a qualified opinion because of scope limitation when beginning inventories have not been observed, depending on the materiality of the inventory amount.

INDEPENDENT AUDITOR'S REPORT

ABC Company

We have audited the accompanying balance sheet of ABC Company (a Texas corporation) as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.[a]

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

Because we were not engaged as auditors until after December 31, 20X1, we were not present to observe the physical inventory taken at that date, and we have not satisfied ourselves by means of other procedures concerning inventory quantities. The amount of the inventory at December 31, 20X1, materially affects the determination of the results of operations and cash flows for the year ended December 31, 20X2.[c]

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 20X2.

In our opinion, the balance sheet referred to in the first paragraph presents fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.[d]

Notes:

[a] The auditors have been engaged to audit all the financial statements; accordingly, the introductory paragraph of the report is unchanged from the auditor's standard report.

[b] The scope paragraph points out that the audit has been performed in accordance with GAAS except as explained in the following paragraph. (See Chapter 2 for a discussion of scope limitations.) When the auditors disclaim an opinion, SAS No. 58 at AU 508.63, footnote 21, generally requires the introductory paragraph to begin "We were engaged to audit . . ." rather than "We have audited . . ." and to omit the scope paragraph of the report (that is, the paragraph that describes the characteristics of an audit). SAS No. 58 at AU 508.67, however, illustrates that auditors need not modify the introductory paragraph or omit the scope paragraph in connection with their disclaimer when the disclaimed financial statements are presented with audited financial statements.

[c] When the auditor disclaims an opinion because of a scope limitation, the substantive reasons for the disclaimer are required to be described in a separate explanatory paragraph of the report.

[d] The report assumes the auditors have been able to satisfy themselves about the consistency of application of accounting principles.

Note that in the preceding report, the auditors have been able to satisfy themselves about consistency.

A scope limitation does not reduce the auditors' responsibility to apply other necessary audit procedures to matters not affected by the scope limitation, i.e., those procedures they would apply to other accounts not affected by the scope limitation. Accordingly, the financial statements on which they disclaimed an opinion should not be marked as unaudited.

REPORTS HAVING MORE THAN ONE MODIFICATION

Reporting Requirements

In unusual circumstances, auditors may need to modify their report for more than one reason. For example, the financial statements may be affected by both a departure from generally accepted accounting principles and an uncertainty about the company's ability to continue as a going concern or the inconsistent application of accounting principles. The choice between types of report modifications is even more difficult when auditors have several reservations about the financial statements, and each alone would call for a different type of report.

In determining how to modify their report when multiple modifications exist, the auditors should consider not only how each modification would be reported individually, but also how the combined modifications affect the financial statements. For example, the auditors may be faced with two unrelated scope exceptions which, if considered individually, would cause them to qualify their opinion. The auditors may decide, however, that the effects on the financial statements of the two situations combined are so pervasive and material that a disclaimer of opinion is warranted. When there is more than one scope limitation, whether separate or interrelated, the authors recommend that the auditors consider disclaiming an opinion.

Authoritative literature does not address the order in which multiple modifications should be presented in the auditor's report. Whenever two or more conditions exist that require a qualified opinion, e.g., a scope limitation and a GAAP departure, two GAAP departures, or two scope limitations, it is believed the reasons for the report modification should be expressed in the order of their importance to the financial statements.

Report Illustrations

Exhibit 3-1 presents views on how to draft numerous types of reports when there is more than one reason for auditors to modify their report. This section then illustrates those reports. Best practices indicate those reports are most likely to be encountered by auditors of small businesses.

Exhibit 3-1

How to Draft Auditor's Reports When Multiple Modifications Exist

Reason for Report Modification	Effect on Auditor's Report
GAAP departure that would lead to a qualified opinion and a going concern uncertainty or a change in accounting principle	Add explanatory paragraph preceding the opinion paragraph describing the GAAP departure, qualify the opinion "except for" the departure, and add an explanatory paragraph following the opinion paragraph describing the going concern uncertainty or the change in accounting principle.
Going concern uncertainty and change in accounting principle	Issue an unqualified opinion and add two explanatory paragraphs following the opinion paragraph describing the going concern uncertainty and the change in accounting principle.
GAAP departure and scope limitation that, individually, would lead to a qualified opinion	In the order of importance, add explanatory paragraphs preceding the opinion paragraph describing the GAAP departure and the scope limitation; qualify the opinion "except for" the GAAP departure and the scope limitation.
Scope limitation that would lead to a qualified opinion together with a going concern uncertainty or a change in accounting principle	Add explanatory paragraph preceding the opinion paragraph describing the scope limitation, qualify the opinion "except for" the limitation, and add an explanatory paragraph following the opinion paragraph describing the going concern uncertainty or the change in accounting principle.
Scope limitation or going concern uncertainty that would lead to a disclaimer of opinion together with a GAAP departure that would lead to a qualified opinion	Describe the going concern uncertainty or the scope limitation and the GAAP departure in explanatory paragraphs preceding the opinion paragraph and disclaim an opinion because of the going concern uncertainty or the scope limitation.
GAAP departure that would lead to an adverse opinion and a going concern uncertainty or a change in accounting principle	Describe the GAAP departure in an explanatory paragraph preceding the opinion paragraph, issue an adverse opinion because of the GAAP departure, and describe the going concern uncertainty or the change in accounting principle in an explanatory paragraph following the opinion paragraph.
GAAP departure that would lead to an adverse opinion and other reservations about GAAP unrelated to the reasons for the adverse opinion	Describe the GAAP departure in an explanatory paragraph preceding the opinion paragraph, issue an adverse opinion because of the GAAP departure, and disclose other reservations about GAAP unrelated to the reasons for the adverse opinion either in the explanatory paragraph that describes the reasons for the adverse opinion or in a separate explanatory paragraph preceding the opinion paragraph.
GAAP departure that would lead to an adverse opinion and a scope limitation that would lead to a qualified opinion	Describe the GAAP departure and the scope limitation in explanatory paragraphs preceding the opinion paragraph and issue an adverse opinion.
GAAP departure that would lead to an adverse opinion and a scope limitation or a going concern uncertainty that would lead to a disclaimer of opinion	Describe the GAAP departure and scope limitation or going concern uncertainty in explanatory paragraphs and either disclaim an opinion or issue an adverse opinion.

* * *

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. When the correction of an error is disclosed in the financial statements of the subsequent period, which of the following statements is accurate?

    a. The reasons for the revision must be disclosed in the notes to the financial statements.

    b. The reasons for the revision must be disclosed in the auditor's report.

    c. Disclosure of a correction of an error involving accounting principles in an explanatory paragraph is not required.

22. Which of the following generally describes the circumstances when the auditors have only been engaged to audit just one basic financial statement, but the company wants to present a complete set of basic financial statements?

    a. "Limited reporting engagement".

    b. "Scope limitation".

23. If auditors need to modify their report for more than one reason such as a scope limitation or going concern uncertainty that would lead to a disclaimer of opinion together with a GAAP departure that would lead to a qualified opinion, the effect on the auditor's report is to:

    a. Describe the going concern uncertainty or the scope limitation and the GAAP departure in explanatory paragraphs preceding the opinion paragraph and disclaim an opinion because of the going concern uncertainty or the scope limitation.

    b. Add explanatory paragraph preceding the opinion paragraph describing the scope limitation, qualify the opinion "except for" the limitation, and add an explanatory paragraph following the opinion paragraph describing the going concern uncertainty or the change in accounting principle.

    c. In the order of importance, add explanatory paragraphs preceding the opinion paragraph describing the GAAP departure and the scope limitation; qualify the opinion "except for" the GAAP departure and the scope limitation.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. When the correction of an error is disclosed in the financial statements of the subsequent period, which of the following statements is accurate? **(Page 151)**

    a. **The reasons for the revision must be disclosed in the notes to the financial statements. [This answer is correct. SAS No.1 *does* require the reasons for the revision to be disclosed in the notes to the financial statements when the correction of an error is disclosed in the financial statements of the subsequent period.]**

    b. The reasons for the revision must be disclosed in the auditor's report. [This answer is incorrect. When the correction of an error is disclosed in the financial statements of the subsequent period, SAS No. 1, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report,* does *not* require the reasons for the revision to be disclosed in the auditor's report.]

    c. Disclosure of a correction of an error involving accounting principles in an explanatory paragraph is not required. [This answer is incorrect. If the correction of the error involves accounting principles, SAS No. 58 requires it to be disclosed in an explanatory paragraph following the opinion paragraph of the auditor's report. This is because errors that involve accounting principles affect the consistency standard.]

22. Which of the following generally describes the circumstances when the auditors have only been engaged to audit just one basic financial statement, but the company wants to present a complete set of basic financial statements? **(Page 153)**

    a. **"Limited reporting engagement". [This answer is correct. When split-level reporting occurs because the auditors have been engaged to audit one basic financial statement, but the company wants to present a complete set of basic financial statements, such circumstances are generally described as a "limited reporting engagement" because the auditor is only reporting on a portion of a complete set of basis financial statements.]**

    b. "Scope limitation". [This answer is incorrect. When split-level reporting occurs because the auditors have been engaged to report on a complete set of financial statements, but due to a scope limitation, are unable to render an audit opinion on all the financial statements, such circumstances are described as a "scope limitation" as a general rule by auditors.]

23. If auditors need to modify their report for more than one reason such as a scope limitation or going concern uncertainty that would lead to a disclaimer of opinion together with a GAAP departure that would lead to a qualified opinion, the effect on the auditor's report is to: **(Page 157)**

    a. **Describe the going concern uncertainty or the scope limitation and the GAAP departure in explanatory paragraphs preceding the opinion paragraph and disclaim an opinion because of the going concern uncertainty or the scope limitation. [This answer is correct. This is the resulting impact to the auditor's report if it must be modified for more than one reason that would lead to a disclaimer of opinion combined with a GAAP departure that would result in a qualified opinion.]**

b. Add explanatory paragraph preceding the opinion paragraph describing the scope limitation, qualify the opinion "except for" the limitation, and add an explanatory paragraph following the opinion paragraph describing the going concern uncertainty or the change in accounting principle. [This answer is incorrect. This would be the resulting effect on the auditor's report when the reason for the report modification is a scope limitation that would lead to a qualified opinion together with a going concern uncertainty or a change in accounting principle.]

c. In the order of importance, add explanatory paragraphs preceding the opinion paragraph describing the GAAP departure and the scope limitation; qualify the opinion "except for" the GAAP departure and the scope limitation. [This answer is incorrect. This would be the resulting effect on the auditor's report when the reason for the report modification is a GAAP departure and scope limitation that, individually, would lead to a qualified opinion.]

FINANCIAL STATEMENTS PREPARED IN CONFORMITY WITH ACCOUNTING PRINCIPLES GENERALLY ACCEPTED OUTSIDE THE U.S.

In today's environment of increased international trade and investment, it is not unusual for auditors to be requested to report on the financial statements of a U.S. company that are prepared in conformity with accounting principles generally accepted in another country for use in that other country. For example, a U.S. company might have non-U.S. investors, or the company might wish to raise capital in another country. Also, the financial statements of the U.S. company might be prepared for inclusion in the consolidated statements of a non-U.S. parent. SAS No. 51, *Reporting on Financial Statements Prepared for Use in Other Countries*, at AU 534, provides guidance in those situations. SAS No. 51 does not apply, however, when the financial statements of a U.S. entity that are presented in conformity with International Financial Reporting Standards (IFRS) for use outside the United States are audited in accordance with U.S. GAAS.

General Requirements

The Statement (at AU 534.01) defines a *U.S. entity* as "an entity that is either organized or domiciled in the United States." It describes the reporting that is appropriate when financial statements of a U.S. entity that are prepared in conformity with accounting principles generally accepted in another country (referred to as "foreign GAAP statements" in this lesson) are used inside or outside the United States. The Statement includes various requirements and options based on factors such as whether the foreign GAAP statements will be used only outside the U.S. or both inside and outside the U.S. Because the intended use of the financial statements affects the appropriate report form, auditors must understand and obtain written representations from management regarding the purposes and uses of the foreign GAAP statements before reporting on them.

Other general requirements that apply when reporting on foreign GAAP financial statements include the following:

- The auditors must follow the general and fieldwork standards of U.S. GAAS, since U.S. GAAS apply to *practice* in the United States. The auditing procedures generally applied under U.S. GAAS may require modification to be responsive to differences between U.S. and the foreign GAAP. For example, if the foreign GAAP do not require a provision for deferred income taxes as U.S. GAAP does, auditing procedures directed toward deferred tax balances would be unnecessary. On the other hand, if the foreign GAAP call for asset revaluation to adjust for the effects of inflation, additional audit procedures not necessary under U.S. GAAS would be necessary to test the revaluation adjustments.
- Obviously, the auditors must understand the foreign GAAP on which they will report. They may read the applicable professional statutes or literature or consult with knowledgeable persons to obtain the requisite knowledge.

Summary of Reporting Guidance

As previously mentioned, there are various reporting options and report forms that are appropriate depending on the use of the foreign GAAP statements. The following table summarizes the alternatives. Also see Exhibit 3-2 for a flow chart that shows the decisions involved in selecting the proper alternatives.

a. Foreign GAAP statements for use *only outside* the U.S.

   Alternative 1. U.S.-style report modified to report on foreign GAAP.

   or—

   Alternative 2. Standard report of the other country.

b. Foreign GAAP statements for *general use inside* the U.S.

   Alternative 3. Standard report modified because of a U.S. GAAP departure.

   optional—

   Alternative 4. May add a paragraph expressing an opinion on conformity with the foreign GAAP to the report in Alternative 3.

c. Foreign GAAP statements for *limited use inside* the U.S.

   May use Alternatives 1 or 2 (easier option) or Alternatives 3 or 4 (more difficult option).

d. Foreign GAAP statements for use *both inside and outside* the U.S.

   Issue two separate reports: the report in Alternative 2 for distribution in the foreign country plus the report in Alternative 3 for distribution in the U.S.

   or—

   Issue one report: the report in Alternative 4 for distribution in both countries.

e. *Co-existing financial statements*, i.e., U.S. GAAP and foreign GAAP.

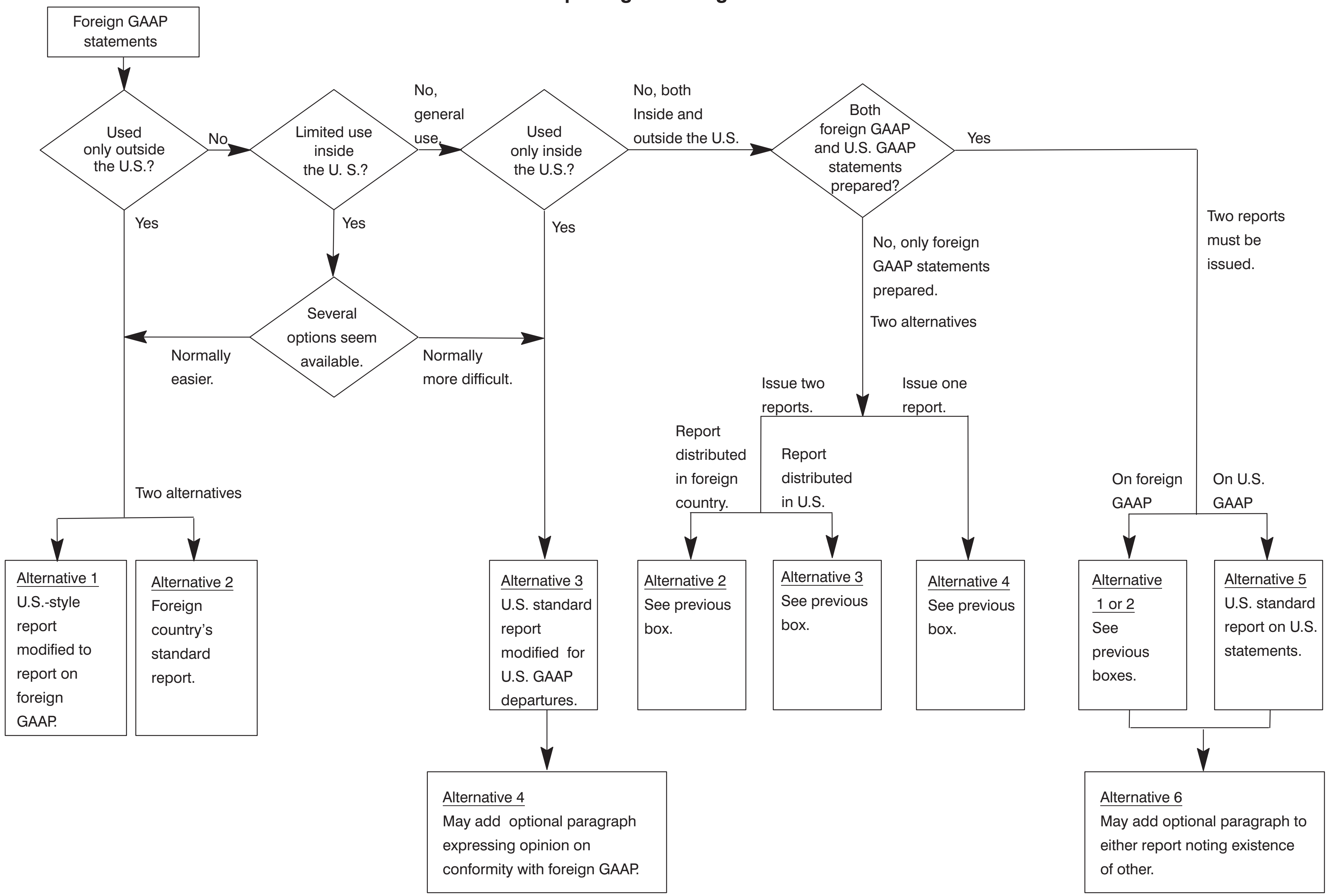
   Issue two reports: the report in Alternatives 1 or 2 for the foreign GAAP statements plus a U.S. standard report (referred to as Alternative 5) for the U.S. GAAP statements.

   optional—

   Alternative 6. May add a paragraph mentioning the existence of the other report to the separate reports.

Exhibit 3-2

Reporting on Foreign GAAP



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GART09

Reporting on Foreign GAAP Financial Statements for Use Only outside the United States

As discussed in item a. below, auditors have a reporting option when the foreign GAAP financial statements of a U.S. company will be used only outside the U.S. They may issue what SAS No. 51 refers to in AU 534.09 as a "U.S.-style report modified to report on financial statements prepared in conformity with accounting principles generally accepted in another country that are intended for use only outside the United States," or they may use the standard audit report of the other country. It generally is preferable to use the first option, i.e., the U.S.-style modified report, because, as will be discussed more fully later, the auditors may have to meet certain additional requirements if they issue the standard report of another country. However, it is recognized that the users in the other country may prefer and request the other country's standard report.

U.S.-style Modified Report (Alternative 1). An example follows of a U.S.-style report modified to report on financial statements prepared in conformity with accounting principles generally accepted in another country for use only outside the United States.

INDEPENDENT AUDITOR'S REPORT

To International Company, Inc.

We have audited the accompanying balance sheet of International Company, Inc. as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended, which, as described in Note X to the financial statements,[a] have been prepared on the basis of accounting principles generally accepted in (name of country). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of International Company, Inc. as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in (name of country).[d]

Notes:

[a] The report refers to the note to the financial statements that states the basis of presentation of the financial statements on which the auditors are reporting, including identification of the nationality of the accounting principles.

[b] The report states that the audit was made in accordance with auditing standards generally accepted in the United States (and, if appropriate, with the auditing standards of the other country).

[c] The report states that U.S. generally accepted auditing standards require audits to be planned and performed to obtain reasonable assurance about whether the statements are free of material misstatement.

[d] The report includes a paragraph that expresses the auditors' opinion about whether the financial statements are presented fairly in conformity with the basis of accounting described. SAS No. 51 (AU 534) states that if the auditors conclude that the financial statements contain a departure from

the foreign GAAP, they should add a separate explanatory paragraph and modify the opinion paragraph as called for by U.S. reporting standards. Although not discussed in the Statement, the authors believe that the other types of report modifications, such as for a scope limitation, also are appropriate when called for by circumstances.

Standard Report of Another Country (Alternative 2). Auditors may use the standard report of another country to report on financial statements of a U.S. company prepared on the basis of accounting principles generally accepted in that country when the statements are for use in the other country. However, the following requirements must be met before using another country's standard report:

- Comply with the auditing standards of the other country (which may include procedures not required by U.S. GAAS) in addition to U.S. GAAS. The necessary knowledge can be obtained from the other country's professional statutes or literature or from consulting knowledgeable persons.

- Be satisfied that such a report would be used by auditors in the other country in similar circumstances.

- Understand, and be in a position to make, the attestations contained in such a report.

- Understand any applicable legal responsibilities in addition to the auditing standards and accounting principles generally accepted in the other country. In some countries, the auditor's report states or implies that the company has complied with legal requirements and that the financial statements are in the format prescribed by law.

Because of those requirements, auditors might prefer to issue the U.S.-style modified report unless they have been requested to use the standard report of another country. Since the U.S.-style report is apt to be more similar to a U.S. standard report, the auditors may feel more comfortable that they understand the assertions and responsibilities embodied in the report. Also, by not using the standard report of another country, the auditors avoid the possibility of having to determine the standard report wording or of having to translate from a foreign language. If using the standard report of another country, naturally the auditors would follow the other country's standard report wording; however, they should consider whether to identify the other country in the report.

Reporting on Foreign GAAP Financial Statements for Use inside the United States

Foreign GAAP financial statements ordinarily are not useful to U.S. users. When financial statements will be used both inside and outside the U.S., two sets of statements might be prepared and reported on. However, if two sets of statements have not been prepared, the foreign GAAP financial statements might be used inside the United States. SAS No. 51 (AU 534) specifies the following uses of foreign GAAP financial statements:

a. Use by a limited party (such as a bank) within the United States who deals directly with the company in a manner that permits that party to discuss differences from U.S. accounting and reporting practices and their significance with the company (referred to in this section as "limited-use" statements).

b. Use in the United States for more than limited purpose (referred to as "general-use" statements).

The following paragraphs discuss reporting in each circumstance.

Foreign GAAP Statements for Limited Use inside the United States. Item (a) above, defines limited use within the United States of financial statements prepared on the basis of accounting principles generally accepted in another country. SAS No. 51 (AU 534) does not directly address reporting on such limited-use statements, other than to state that there is no intention to preclude the use of limited-use statements. It is believed, however, that the Statement implies that auditors may issue *either* a U.S.-style modified report, or the standard report of the other country. In short, it is believed that foreign GAAP financial statements for *limited* use inside the U.S. may be reported on as if they were for use outside the U.S. The significant point is that either report expresses only an opinion about conformity with the foreign GAAP and is not modified for a departure from U.S. GAAP, as is required when the statements are for general use inside the U.S. It is believed that auditors also could follow the guidance below for statements having limited use in the U.S.) The crucial determinant of the appropriate type of report is whether the U.S company can directly discuss the foreign GAAP financial statements with the U.S. limited party users.

Foreign GAAP Statements for General Use inside the United States. As items (a) and (b) above imply, *general* use means use for more than limited purposes. In other words, the U.S. company cannot directly discuss the foreign GAAP financial statements with the U.S. users. In those cases, auditors should use the U.S. standard form of report, modified as appropriate because of departures from accounting principles generally accepted in the U.S. Thus, the report should (a) include an explanatory paragraph preceding the opinion paragraph that discloses, or refers to the note to the financial statements that discloses, the reasons for the report modification and the effects of the departure, if reasonably determinable and (b) express a qualified opinion on the financial statements. The Statement allows (but does not require) auditors to add another paragraph to the report expressing an opinion about whether the financial statements are presented in conformity with accounting principles generally accepted in the other country. (Auditors might add such a paragraph when, in addition to having general use inside the U.S., the financial statements will be used outside the U.S., and the auditors decide not to issue a separate standard report of the other country for use in that country.)

Presented below is an example of a U.S standard report that is modified for a departure from U.S. GAAP and that includes an additional opinion paragraph on conformity with foreign GAAP. The report is appropriate when foreign GAAP financial statements have been prepared for general use inside the United States.

INDEPENDENT AUDITOR'S REPORT

To International Company, Inc.

We have audited the accompanying balance sheet of International Company, Inc. as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As more fully described in Note X, the Company's policy is to prepare its financial statements on the basis of accounting principles generally accepted in (name of country), which do not require a provision for deferred income taxes based on differences between the bases of assets and liabilities for financial and income tax reporting.[a] Accounting principles generally accepted in the United States of America, in our opinion, require that deferred income taxes be provided in such circumstances. If deferred taxes of $XXX were provided as of December 31, 20X1, in conformity with accounting principles generally accepted in the United States of America, deferred income taxes payable would be increased by $XXX and retained earnings and net income would be decreased by $XXX and $XXX, respectively.[b]

In our opinion, except for the effects of the matters discussed in the preceding paragraph, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of International Company, Inc. as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.[c]

[However, in our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of International Company, Inc. as of December 31, 20X1, and the results of its operations and cash flows for the year then ended in conformity with accounting principles generally accepted in (name of country)].[d]

Notes:

[a] A separate paragraph refers to the note to the financial statements that identifies the foreign GAAP basis on which the financial statements are presented and describes the significant differences between that basis and U.S. GAAP.

[b] The separate paragraph discloses the principal effects on the financial statements of using the foreign GAAP. (That disclosure need not be made in the report if the effects are described in the notes to the financial statements.) If the effects are not reasonably determinable, the report should so state. In that case, the last sentence of the paragraph, which begins, "If deferred taxes of $XXX were provided," would be replaced with the following sentence:

> The effects of that departure from U.S. generally accepted accounting principles on the accompanying financial statements of International Company, Inc. are not reasonably determinable.

[c] The opinion paragraph is modified because of the departure from U.S. GAAP. In this example, a qualified opinion is expressed. If the effects of the departure were very material and pervasive to the financial statements, an adverse ("do not present fairly") opinion might have to be given. Although not discussed in the Statement, the authors believe that in addition to modification because of the departure from U.S. GAAP, other report modifications, such as for a scope limitation, are appropriate when called for by circumstances.

[d] The auditors have the option of adding another paragraph that expresses an opinion on whether the financial statements are presented in conformity with accounting principles generally accepted in the other country. That optional paragraph generally should be modified as appropriate if there is a departure from the foreign GAAP or other circumstance requiring recognition in the opinion paragraph under U.S. reporting standards, such as a scope limitation.

Foreign GAAP Financial Statements for Use Both inside and outside the United States

As previously indicated, auditors have two reporting options when foreign GAAP statements will be used both inside and outside the United States:

a. Issue two reports on foreign GAAP statements: the standard report of the other country for distribution in that country *and* a U.S. standard report modified because of a departure from GAAP for distribution in the U.S.

b. Issue only a U.S. standard report modified because of a departure from U.S. GAAP and include an additional paragraph expressing an opinion on conformity with the foreign GAAP for distribution in both countries.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

24. If foreign GAAP statements are for use only outside the U.S., which of six possible alternatives is appropriate?

    a. Alternative 2.

    b. Alternative 4.

    c. Alternative 5.

    d. Alternative 6.

25. When the foreign GAAP financial statements of a U.S. company will be used only outside the U.S., auditors have a reporting option. Which of the following reporting options is generally preferable?

    a. U.S.-style modified report.

    b. The standard audit report of the other country.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

24. If foreign GAAP statements are for use *only outside* the U.S., which of six possible alternatives is appropriate? **(Page 162)**

    a. Alternative 2. [This answer is correct. If foreign GAAP statements are for use *only outside* the U.S., Alternative 2 (use as a standard report of the other country) is one of two alternative report forms that may be used per SAS No. 51.]

    b. Alternative 4. [This answer is incorrect. According to SAS No. 51, alternative 4 (use to add a paragraph expressing an opinion on conformity with the foreign GAAP to report in Alternative 3) is one of two alternatives that are appropriate if foreign GAAP statements are for *general use inside* the U.S.]

    c. Alternative 5. [This answer is incorrect. Alternative 5 (a U.S. standard report for the U.S. GAAP statements) is one of two alternative reporting options that are appropriate if there are *co-existing financial statements* (U.S. GAAP and foreign GAAP) per SAS No. 51.]

    d. Alternative 6. [This answer is incorrect. According to SAS No. 51, alternative 6 (use to add a paragraph mentioning the existence of the other report to the separate reports) is another of two alternative report forms that are appropriate if there are *co-existing financial statements.*]

25. When the foreign GAAP financial statements of a U.S. company will be used only outside the U.S., auditors have a reporting option. Which of the following reporting options is generally preferable? **(Page 165)**

    a. U.S.-style modified report. [This answer is correct. The U.S.-style modified report is preferable since this report will not require auditors to meet any additional requirements of the other country. However, it should be noted that the users in the other country may prefer and request the use of the other country's standard report in lieu of the U.S.-style modified report.]

    b. The standard audit report of the other country. [This answer is incorrect. The U.S.-style modified report is preferable because, when using the standard audit report of the other country, auditors may have to meet certain additional requirements.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (GARTG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

19. Of the following statements, which one is accurate regarding emphasis of a matter (EOM) paragraphs?

    a. They are always required in financial statements.

    b. They are usually required in financial statements.

    c. They are rarely required in financial statements.

    d. They are added solely at the auditor's discretion.

20. EOM paragraphs may be useful and appropriate in any of the following circumstances **except**:

    a. The reporting entity is dependent on federal cost reimbursement programs, such as low-income housing projects.

    b. The reporting entity is in an industry that is economically depressed.

    c. The reporting entity is a development stage company.

    d. Related party transactions have been consummated on terms equivalent to arm's-length transactions, but management cannot substantiate such representation.

21. Which of the following statements is accurate regarding errors that involve accounting principles?

    a. Such errors do not affect the consistency standard.

    b. Auditors should issue an unqualified opinion on the revised financial statements.

    c. Auditors need not describe errors in an explanatory paragraph.

    d. Do not select this answer choice.

22. According to the text, based on SSARS No. 1, AR 100, some accountants believe if split-level reporting is used that it is appropriate for nonpublic companies to receive an audit opinion on ____________ and a review report on the other statements.

    a. The statements of income.

    b. The statements of retained earnings.

    c. The balance sheet.

    d. The statements of cash flows.

23. If auditors need to modify their report because of a GAAP departure that would lead to an adverse opinion and a scope limitation that would lead to a qualified opinion, the effect on the auditor's report is to:

    a. Describe the GAAP departure in an explanatory paragraph preceding the opinion paragraph, issue an adverse opinion because of the GAAP departure, and describe the going concern uncertainty or the change in accounting principle in an explanatory paragraph following the opinion paragraph.

b. Describe the GAAP departure in an explanatory paragraph preceding the opinion paragraph, issue an adverse opinion because of the GAAP departure, and disclose other reservations about GAAP unrelated to the reasons for the adverse opinion either in the explanatory paragraph that describes the reasons for the adverse opinion or in a separate explanatory paragraph preceding the opinion paragraph.

c. Describe the GAAP departure and scope limitation or going concern uncertainty in explanatory paragraphs and either disclaim an opinion or issue an adverse opinion.

d. Describe the GAAP departure and the scope limitation in explanatory paragraphs preceding the opinion paragraph and issue an adverse opinion.

24. If foreign GAAP statements are for general use inside the U.S., which of the following alternatives is appropriate?

a. Alternative 1.

b. Alternative 3.

c. Alternative 5.

d. Alternative 6.

25. When financial statements are for use in another country, auditors may use the standard report of the other country to report on financial statements of a U.S. company prepared on the basis of accounting principles generally accepted in that other country. Which of the following statements describing requirements for use of another country's standard report is **inaccurate**?

a. Comply with the auditing standards of the other country rather than U.S. GAAS.

b. Verify whether such a report would be used by auditors in the other country in similar circumstances.

c. Understand, and be in a position to make, the attestations contained in such a report.

d. Understand any applicable legal responsibilities in addition to the auditing standards and accounting principles generally accepted in the other country.

Lesson 4: Additional Information Accompanying The Basic Financial Statements

INTRODUCTION

This lesson deals with additional information that should accompany basic financial statements.

Learning Objectives:

Completion of this lesson will enable you to:

- Summarize additional information in auditor-submitted documents, modified reports, required supplementary information, and other information in client-prepared documents.
- Describe the auditor's responsibility regarding nonaccounting data and charts and graphs in auditor-submitted documents and when audited financial statements are included in client-prepared documents.

BACKGROUND INFORMATION

Authoritative Literature

Authoritative literature for reporting on additional information included in or presented with financial statements is found in these Statements on Auditing Standards:

- SAS No. 8 (AU 550), *Other Information in Documents Containing Audited Financial Statements*. This Statement requires auditors to read "other information" in client-prepared annual reports and other documents containing financial statements on which they have reported and to consider (a) whether that information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements and (b) whether it contains a material misstatement of fact. Auditors do not have to report on client-prepared other information but should consider whether the financial statements, their report, or both should be revised when they find an inconsistency. Their actions on finding a material misstatement of fact depend on their judgment in the particular circumstances. SAS No. 98, *Omnibus Statement on Auditing Standards—2002*, amends SAS No. 8 to clarify that auditors are allowed (but not required) to issue a report providing an opinion, in relation to the basic financial statements taken as a whole, on other information that has been subjected to the auditing procedures applied in the audit of those basic financial statements. The auditor reports on such information using the guidance in SAS No. 29.

- SAS No. 29 (AU 551), *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*. This Statement provides guidance for reporting on information in addition to a client's basic financial statements included in documents that auditors submit to clients or others. Auditors have a responsibility to report on all the information in documents containing audited financial statements that they submit to clients or others.

- SAS No. 52 (AU 558), *Omnibus Statement on Auditing Standards—1987*. This Statement describes circumstances that require auditors to report on supplementary information required by GAAP. The Statement also gives auditors guidance concerning procedures to be applied to such information. Auditors do not have a responsibility to report on supplementary information required by GAAP unless:

  a. the required information is omitted,

  b. the auditors conclude that the measurement or presentation of the information departs materially from prescribed guidelines,

  c. the auditors are unable to complete the prescribed procedures, or

  d. the auditors are unable to remove substantial doubts about whether the information conforms to prescribed guidelines.

SAS No. 98, *Omnibus Statement on Auditing Standards—2002*, amends SAS No. 52 to clarify that auditors are allowed (but not required) to issue a report providing an opinion, in relation to the basic financial statements taken as a whole, on required supplementary information that has been subjected to the auditing procedures applied in the audit of those basic financial statements.

- SAS No. 42 (AU 552), *Reporting on Condensed Financial Statements and Selected Financial Data*. This Statement establishes requirements for reporting on such information in client-prepared documents in a very narrow set of circumstances. For nonpublic entities, this SAS provides guidance on reporting on selected financial data in a client-prepared document that also includes financial statements on which the auditors have reported.

Recently Approved Statements on Auditing Standards

The Auditing Standards Board has issued exposure drafts of the following proposed Statements on Auditing Standards that would amend existing authoritative literature for additional information accompanying the basic financial statements:

- *Other Information in Relation to the Financial Statements Taken as a Whole* supersedes SAS No. 29 (AU section 551), *Reporting on Information Accompanying the Basic Financial Statements in Auditor-submitted Documents*.

- *Other Information in Documents Containing Audited Financial Statements* supersedes SAS No. 8 (AU section 550), *Other Information in Documents Containing Audited Financial Statements*.

- *Required Supplementary Information* supersedes the portions of SAS Nos. 52 and 98 (AU section 558) that address reporting on supplementary information required by GAAP.

All three Statements would be effective for audits of financial statements for periods beginning on or after December 15, 2010. (The effective date is provisional but will not be earlier than December 15, 2010.) As exposed, early application is permitted. Auditors should be alert for the issuance of the final SASs. The status of the exposure drafts can be monitored at **www.aicpa.org**.

Definitions

Authoritative literature uses several terms to describe information that accompanies the basic financial statements. For example, the terms *other information*, *additional information*, and *supplementary information* are often used interchangeably to designate information that is presented in addition to the basic financial statements. Also, some accountants, in day-to-day speech, may refer to notes that accompany the basic financial statements as another type of "other information." Throughout this lesson, the following terms are used:

- *Basic Financial Statements*—authoritative literature defines basic financial statements to include:

  - a balance sheet;

  - a statement of income;

  - a statement of retained earnings;

  - disclosure, when applicable, of changes in categories of stockholders' equity other than retained earnings;

  - a statement of cash flows;

  - descriptions of accounting policies and related notes to financial statements; and

  - schedules and explanatory material that are identified as being part of the basic financial statements.

SFAS No. 130, *Reporting Comprehensive Income* (FASB ASC 220), requires companies with certain components of comprehensive income to also report total comprehensive income and its components in the basic financial statements. The information might be included in an existing statement, such as the statement of income or statement of changes in stockholders' equity. Another alternative is to present a separate statement of comprehensive income. In that case, the statement would also be a basic financial statement.

- *Other Information*—information presented outside the basic financial statements that is included in a *client-prepared* annual report or other document containing basic financial statements on which auditors have reported.

- *Additional Information*—information presented outside the basic financial statements that is included in an *auditor-submitted* document containing basic financial statements on which auditors have reported. Such information can be, and often is, identical to what is called *other information* in a client-prepared document. (The only distinction is that in one case, the information appears in a client-prepared document, while in the other, the information appears in an auditor-submitted document.)

- *Supplementary Information Required by GAAP*—specific information that generally accepted accounting principles require certain entities to present to supplement the financial statements.

The use of the preceding terms distinguish the auditors' responsibilities for various types of information, but other terminology is equally acceptable. For example, the information that this course terms "additional information" often is called "supplementary information" in practice.

Is the Information a Part of the Basic Financial Statements?

It is important to distinguish between information considered part of the basic financial statements and additional information since the auditors' reporting obligation for each differs. In both cases, the auditors must report on the information when it is included in an auditor-submitted document. If the information is considered part of the basic financial statements, however, the auditors' standard report should cover it. On the other hand, if the information is deemed outside the basic statements (that is, additional information), the auditor must report on it separately by either (a) adding an additional paragraph to the standard report or (b) issuing a separate report on such information.

There is often confusion about whether schedules and explanatory materials are part of the basic financial statements or whether they should be considered *outside* the basic statements and, thus, additional information. For example, a schedule detailing the account balances comprising the total general and administrative expense caption on the statement of income may be either, depending upon where the information is presented. To avoid confusion, the following should be considered:

a. Schedules providing detail of line items in the financial statements should be considered additional information.

b. All additional information should be placed after the basic financial statements and notes and, ordinarily, be preceded by a title page marked "ADDITIONAL INFORMATION."

c. If the client wishes to provide detail of line items in the basic financial statements and insists that the detail be part of the basic financial statements, the detail should be presented on the face of the financial statements or in the accompanying notes.

d. If the client insists that a schedule providing detail of a line item in a basic financial statement be included as part of the basic financial statements, the schedule should be either (a) treated as an additional page of that basic financial statement and titled accordingly or (b) titled as a schedule and referred to as such in the auditors' report (for example, "We have audited the accompanying balance sheet of ABC Company as of December 31, 20X1, and the related statement of income and retained earnings, statement of cash flows, and schedule of operating expenses for the year then ended. . . .").

Are Forecasts and Projections That Accompany the Basic Financial Statements Considered to Be Additional Information?

Prospective financial statements (financial forecasts or projections) that are presented with audited financial statements should not be considered additional information for audit reporting purposes. Such information should be reported on in accordance with the AICPA's authoritative standard on prospective financial information. Reporting as described in the standard, however, does not apply to forecasts for *expired* periods, e.g., budget information for an expired period. Such information should be treated as additional information. Expired budget information generally is not susceptible to auditing procedures. (The guidance in this paragraph is not applicable to financial statements of state and local governmental units, for which budgetary comparison information is considered part of the basic financial statements.)

Auditor-submitted versus Client-prepared Documents

Once the information that accompanies financial statements is deemed to be other than part of the *basic financial statements*, the key for determining the auditor's reporting responsibility with regard to the information is whether it is included in an *auditor-submitted* or *client-prepared* document.

Many auditors question why auditors' reporting responsibilities for information in an auditor-submitted document differ from their responsibilities for information in a client-prepared document. The reason for the difference is because of the way financial statement users may perceive auditors' responsibilities based on the difference in appearance between the two types of documents.

Auditor-submitted documents are bound in the firm's report cover and sometimes printed on paper bearing the auditors' logo or watermark. The appearance of those documents often leads readers to assume that auditors are taking some degree of responsibility for all the information in the document. As a result, auditors must disclaim an opinion on any additional information not covered by their audits and indicate the responsibility taken for information that they have audited.

Client-prepared documents, on the other hand, appear to be the responsibility of the client. For example, an annual report to stockholders usually is clearly discernible as the work of the client rather than the auditor. In such documents, the reader would generally expect the auditor's report to cover only the information identified in it. It is generally clear that other information in the document is furnished by management.

If a question arises concerning whether documents are client-prepared or auditor-submitted, the answer can usually be determined by the appearance of the report—more specifically, the report cover and the use of the auditors' logo or watermark.

Co-existing Financial Statements

Auditors should be aware that problems may arise when audited financial statements are contained in both an auditor-submitted document and a client-prepared document. For example, auditors may submit documents containing the basic financial statements, additional information, and their reports to clients or others. Clients also may issue separate documents containing only the basic financial statements and the auditor's standard report. In those circumstances, it is important that the basic financial statements in all co-existing documents include all the information considered necessary to conform with GAAP. Auditors should be satisfied that the additional information included in the auditor-submitted document would not support the contention of potential users of the client-prepared document that the basic financial statements alone were not presented in conformity with GAAP because of inadequate disclosure of material information known to the auditors.

EXPLICIT REPORTING AND EXCEPTION REPORTING

The reporting requirements associated with the types of information discussed in this lesson fall into two general categories—explicit and exception. By "explicit reporting," it is meant that the auditors disclose in their report the degree of responsibility they have for the information. By "exception reporting," it is meant that the auditors are silent with respect to the information unless (a) they disagree with the *content of the information*, (b) required information is omitted, (c) they are unable to perform prescribed procedures with respect to the information, or (d) they are unable to remove substantial doubts about whether the information conforms to prescribed guidelines.

Explicit Reporting Requirements

The auditor's report must disclose the responsibility assumed for the information outside the basic financial statements when:

a. it is included in an auditor-submitted document, or

b. it is included in a client-prepared document and the client asks the auditors to report on it.

Exception Reporting Requirements

Unless one of the situations described above exists, auditors need not report on the information when:

a. it is supplementary information required by GAAP in a client-prepared document, or

b. it is included in a client-prepared document, and the client has not asked them to report on it.

ADDITIONAL INFORMATION IN DOCUMENTS SUBMITTED BY THE AUDITOR

Reporting Requirements

When auditors submit a document containing audited financial statements to their clients or others, they have a responsibility to report on all the information in the document. The extent of the additional information may range from a single schedule or consolidating statements to numerous schedules, details, and comments of a financial or nonfinancial nature.

Types of Additional Information

Data that are frequently included as additional information in auditor-submitted documents containing audited financial statements include the following items:

Assets

- Cash
  - Summary of cash balances
- Securities (current or noncurrent)
  - Summary of securities owned (sometimes also including related income)
  - Summary of changes during the period in securities owned and of income from securities
- Receivables
  - List of notes receivable
  - Summary of trade accounts and contracts classified according to age or due date (sometimes in comparison with a corresponding summary as of the close of the preceding period)
  - List of significant debtors by name and balance
  - Terms of sale
  - Changes in allowance for doubtful accounts
  - Bad debt experience and collection ratios
- Inventories
  - Summary of inventories by principal classifications (sometimes in comparison with a corresponding summary as of the close of the preceding period)

Elaboration of the basis on which inventories are stated, such as a description of the method of computing overhead, recognition accorded to slow-moving and obsolete items, and criteria used in establishing market prices
Rates of turnover

- Investments in, and accounts with, subsidiaries
  Summary showing subsidiaries individually and the related equities
  Description of business of subsidiaries
  Separate financial statements of subsidiaries

- Property and equipment
  Schedule of asset accounts by principal classification, showing changes during the period and related depreciation allowances and changes
  Significant changes in the properties accounts
  Construction in progress or commitments for plant expansion
  Difference between book and tax depreciation
  Policy as to fully amortized costs
  Fully amortized costs pertaining to assets still in use
  Elaboration of important features of leases

- Intangible assets
  Elaboration of description

- Other assets and deferred charges
  Schedule of miscellaneous investments (stocks, bonds, mortgages, land contracts, real estate, or other)
  Schedule of deferred charges
  Schedule of miscellaneous receivables (noncurrent trade, officers and employees, deposits, and other)

<u>Liabilities</u>

- Notes payable (current and noncurrent)
  Schedule of individual issues or obligations
  Provisions of governing instruments that are not required to be disclosed in notes to financial statements
  Changes in borrowing during the period

- Accounts payable and accrued expenses
  Composition of current liability classifications
  Status of tax returns

- Deferred income (or credits)
  Summary of changes during the period
  Purposes or sources of accounts

<u>Results of Operations</u>

- Range of monthly sales

- Classification of sales

- Manufacturing expenses (if not included in the schedule of cost of products sold)

- Selling, administrative, and general expenses

- Other income
- Other deductions

Organizational Data

- Date of organization
- State of incorporation
- Duration of charter
- Location of principal plants and properties
- Directors and officers
- List of stockholders (appropriate only for closely held corporations)
- Subsidiaries
- Branches
- Significant leases

Presentation of Additional Information

Additional information in an auditor-submitted document should be in the same document as the basic financial statements. The title on the covers of reports containing the financial statements and additional information should be descriptive, such as "Financial Statements and Additional Information." All schedules containing additional information should be appropriately labeled, such as "Additional Information."

Whenever practicable, the additional information should be presented as a separate section of the document following the notes to financial statements, physically separated from the basic financial statements by an otherwise blank piece of paper containing the words, "ADDITIONAL INFORMATION," or other descriptive title. The title of the separator sheet should be consistent with the title used on the report cover, in the table of contents, and in the auditor's report.

Some auditors find that separating a report containing additional information into the following sections, preferably with an index tab to mark each section, facilitates users' understanding of the auditors' responsibilities for the information in the document:

Financial statements with standard report:

Independent auditor's report

Financial statements

Notes to financial statements

Additional information:

Independent auditor's report on additional information

Additional analyses, schedules, and data

Location of Report on Additional Information

An auditor's report on additional information may be either presented separately in the auditor-submitted document or included as a separate paragraph of the auditor's report on the financial statements. The report should immediately precede the additional information, which helps further distinguish it from the basic financial statements. On the other hand, when auditors report on other information in a client-prepared document, include the report on the other information as a separate paragraph of the auditor's report on the basic financial statements.

Auditor's Standard Report on Additional Information

The standard report on additional information in an auditor-submitted document is illustrated in SAS No. 29 at AU 551.12 and presented in Exhibit 4-1.

Exhibit 4-1

Auditor's Standard Report on Additional Information

Report Elements	Report Text
The Title	INDEPENDENT AUDITOR'S REPORT ON ADDITIONAL INFORMATION
Addressing the Report	To the Board of Directors and Stockholders of ABC Company
Location of Report on Basic Financial Statements Purpose of Audit Identification of Additional Information Purpose of Additional Information Auditors' Opinion on Additional Information	Our report on our audit of the basic financial statements of ABC Company for 20X1 appears on page XX. That audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The [identify the additional information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.
Firm's Signature and Location	Firm's signature City, State
Date of the Auditor's Report	February 15, 20X2

* * *

The Title

SAS No. 29 (AU 551) does not require auditors to title their report on additional information. However, SAS No. 58 (AU 508) requires a title for the auditor's standard report. Accordingly, best practices indicate that the report on additional information should be titled, and the title should include the word "independent."

Best practices indicate using the term *additional information* in auditor-submitted documents to distinguish the information from supplementary information required by GAAP. To some readers, the term *supplementary information* implies that the information is needed for an understanding of the basic financial statements or that the basic financial statements would be incomplete without the information.

The following titles also are used in practice:

- Independent Auditor's Report on Supplementary Information
- Independent Auditor's Report on Accompanying Information
- Independent Auditor's Report on Other Information
- Independent Auditor's Report on Other Financial Information

- Independent Auditor's Report on Accompanying Financial Information

Remember, the description of the information used in the title should conform to the description used on the report cover and in the table of contents.

Addressing the Report

Reports on additional information usually are addressed to the same parties as the auditor's report on the basic financial statements. However, some accountants prefer to address the report to "management," because it is usually the management of the company that requests the additional information.

Purpose of Audit

The auditor's report on additional information should state that the audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The purpose of an audit in accordance with generally accepted auditing standards is to form an opinion on those statements taken as a whole. Nevertheless, an audit of basic financial statements often encompasses the additional information. If not, the auditors may choose to modify or redirect certain procedures applied in their audit of the basic financial statements so that they may form an opinion on whether the additional information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

In reporting on additional information, the measure of materiality is the same as the auditors use in forming an opinion on the basic financial statements.

Identification of Additional Information

The report should identify the additional information by using a descriptive title or indicating the page number of the document where the additional information is presented.

Purpose of Additional Information

The report should state that the additional information is presented for purposes of additional analysis and is not a required part of the basic financial statements. Auditors may refer to any regulatory agency requirements that apply to the information presented.

Auditors' Opinion on Additional Information

The report should include the auditors' opinion on whether the additional information is fairly stated in all material respects in relation to the basic financial statements taken as a whole or a disclaimer of opinion depending on whether the information has been subjected to auditing procedures applied in the audit of the basic financial statements. Auditors may express an opinion on a portion of the accompanying information and disclaim an opinion on the remainder.

If the additional information is materially misstated in relation to the basic financial statements taken as a whole, auditors should discuss the matter with their clients and propose appropriate revision of the information. If clients do not agree to revise the additional information, auditors should either modify their reports on the additional information and describe the misstatement, or refuse to include the information in the document.

Auditors should consider the effect of any modifications in their standard report when reporting on accompanying information. When they issue a modified report on the basic financial statements, they should make clear the effects of the modification on any accompanying information as well. When they express an adverse opinion or disclaim an opinion on the basic financial statements, they should not express an opinion on any accompanying information. An expression of such an opinion in those circumstances would be inappropriate, because it may tend to overshadow or contradict the disclaimer of opinion or adverse opinion on the basic financial statements.

Firm's Signature and Location

When auditors report separately on additional information, their signature and location generally need to be repeated.

Date of the Auditor's Report

The auditor's report on additional information should be dated the same as the report on the basic financial statements.

Additional Information Presented for Periods Prior to Those of the Financial Statements

Occasionally, auditors may be asked to report on additional information relating to periods prior to those for which basic financial statements are presented. For example, the client may request trend data for the years 20X1 through 20X5 in addition to the financial statements for the years 20X4 and 20X5. SAS No. 29 (AU 551) does not specify the type of report to be provided on the data for the earlier years, that is, for the years 20X1 through 20X3.

In those circumstances, best practices indicate that auditors may give the same opinion on the data for earlier periods as they give on the data for years covered by the basic financial statements. SAS No. 29, in a footnote to AU 551.15, states that approach is appropriate for reporting on 10-year historical pension information that is presented in accordance with GASB requirements.

Generally, the following form of report is appropriate.

INDEPENDENT AUDITOR'S REPORT
ON ADDITIONAL INFORMATION

To ABC Company

Our report on our audits of the basic financial statements of ABC Company for the years ended December 31, 20X5 and 20X4, appears on page X. Those audits were conducted for the purpose of forming an opinion on such financial statements taken as a whole. The [identify information related to the 20X5 and 20X4 financial statements] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements for the years ended December 31, 20X5 and 20X4, taken as a whole.

We also have previously audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheets of ABC Company as of December 31, 20X3, 20X2, and 20X1, and the related statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 20X3 (none of which is presented herein), and we expressed unqualified opinions on those financial statements. In our opinion, the [identify information related to 20X3, 20X2, and 20X1 financial statements] is fairly stated in all material respects in relation to the basic financial statements from which it has been derived.

When the auditors have not audited the basic financial statements for some of the years for which additional information is presented, they should disclaim an opinion on the additional information for those years.

DISCLAIMER OF OPINION PERTAINING TO ADDITIONAL INFORMATION

Circumstances Requiring Disclaimer

If the additional information in an auditor-submitted document is not subjected to auditing procedures applied in the audit of the basic financial statements, the auditors should disclaim an opinion on it. Auditors may express an opinion on a portion of the additional information and disclaim an opinion on the remainder.

Designating the Information

When auditors disclaim an opinion on all or part of the additional information, the information on which they are disclaiming an opinion should be clearly designated as "UNAUDITED" or should include a reference to the disclaimer of opinion.

Sample Report

An example of the auditors' disclaimer of opinion on all additional information in an auditor-submitted document follows.

INDEPENDENT AUDITOR'S REPORT
ON ADDITIONAL INFORMATION

To ABC Company

Our report on our audit of the basic financial statements of ABC Company for 20X1 appears on page X. That audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The [identify the additional information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements,[a] and, accordingly, we express no opinion on it.[b]

Notes:

[a] The disclaimer of opinion in the preceding report contains most of the basic elements of the auditor's unqualified report on additional information, except that instead of expressing an opinion on the additional information, the disclaimer states that the additional information has not been subjected to auditing procedures applied in the audit of the basic financial statements.

[b] The auditors express no opinion on that information.

May a Compilation or Review Report Be Issued in Lieu of the Disclaimer?

No. SSARS No. 1 (AR 100) only applies to financial statements. Additional information, by definition, is not a financial statement. Also, SSARS No. 1 discusses reporting only on additional information that accompanies compiled or reviewed financial statements, *not audited financial statements*. Furthermore, although SSARS No. 13, *Compilation of Specified Elements, Accounts, or Items of a Financial Statement*, permits accountants to compile specified elements, accounts, or items of a financial statement, it does not change the fact that a compilation report cannot be issued in lieu of the disclaimer when the specified element is presented as additional information accompanying audited financial statements. When the additional information accompanies audited financial statements, auditors should follow the guidance in SAS No. 29 (AU 551).

Supplementary Information Prepared Using Different Basis of Accounting

In most cases, a disclaimer of opinion should be issued on supplementary information that is not presented on the same basis of accounting as the basic financial statements, unless the information on the other basis of accounting has been subjected to auditing procedures applied in the audit of the basic financial statements. An example of a disclaimer of opinion on such information is as follows:

INDEPENDENT AUDITOR'S REPORT
ON ADDITIONAL INFORMATION

To ABC Company

Our report on our audit of the basic financial statements of ABC Company for 20X1 appears on page X. That audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. As disclosed in Note X to the financial statements, the Company prepares its basic financial statements using [describe basis of accounting used in the basic financial statements]. The accompanying additional balance sheet and statement of income were prepared for purposes of additional analysis using [describe basis of accounting used in the additional information] and are not a required part of the basic financial statements. The adjustments made in preparing the supplemental presentations were not subjected to audit procedures as part of the audit of the basic financial statements and, accordingly, we express no opinion on the additional financial statements. The accompanying additional financial statements are not intended to present ABC Company's financial position or results of operations.

DISCLAIMER OF OPINION PERTAINING TO PART OF THE ADDITIONAL INFORMATION

The auditor may express an opinion on a portion of the additional information and disclaim an opinion on the remainder. An example of that type of report follows.

INDEPENDENT AUDITOR'S REPORT
ON ADDITIONAL INFORMATION

To ABC Company

Our report on our audit of the basic financial statements of ABC Company for 20X1 appears on page X. That audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The additional information presented in Schedules I, II, and III is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information, except for that portion marked "unaudited,"[a] on which we express no opinion,[b] has been subjected to the auditing procedures applied in the audit of the basic financial statements, and, in our opinion, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Notes:

[a] The report specifically identifies the information that the auditor has not audited. In this case, such information is identified as "Unaudited." In some cases, the auditors may need to disclaim an opinion on entire schedules. In those circumstances they may indicate the title of the unaudited schedules in their report.

[b] The report states that the auditors do not express an opinion on the information identified as unaudited.

Auditors sometimes may be requested to report on additional information relating to periods prior to those for which basic financial statements are presented. When auditors have not audited the basic financial statements for some of the years for which additional information is presented, they should disclaim an opinion on the additional information for those years. The following report is an example of the report auditors may issue when they have only audited the basic financial statements for 20X4 and 20X5, and additional information is presented for the 5-year period from 20X1–20X5:

INDEPENDENT AUDITOR'S REPORT
ON ADDITIONAL INFORMATION

To ABC Company

Our report on our audits of the basic financial statements of ABC Company for the years ended December 31, 20X5 and 20X4, appears on page X. Those audits were conducted for the purpose of forming an opinion on such financial statements taken as a whole. The [identify information related to the 20X5 and 20X4 financial statements] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements for the years ended December 31, 20X5 and 20X4, taken as a whole.

The [identify information related to the 20X3, 20X2, and 20X1 financial statements] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the basic financial statements, and, accordingly, we express no opinion on it.

As discussed in TIS 9110.15, third-party payors may require health care organizations to prepare and submit "cost reports" as a condition of participation in a payor's program. The most common examples are Medicare and Medicaid. In many cases, the health care organization includes their cost report as additional information accompanying the basic financial statements.

QUALIFIED AND ADVERSE REPORTS

Misstated Information

If the auditors' procedures lead them to believe that any of the additional information is materially misstated in relation to the basic financial statements taken as a whole, they should discuss their reservations with the client and propose that the information be changed. If their client refuses to revise the information, the auditors should issue either a qualified or adverse report, depending upon the circumstances, or refuse to include the information in the document.

Effect of Qualification on Basic Financial Statements

When auditors express a qualified opinion on the basic financial statements, they should consider the effect of that qualification on the additional information. If the auditor's report on the additional information is included in a separate section of the document, the report should refer to the qualification. If the qualification results from matters that also affect the additional information, the auditor's report on the additional information also should be appropriately qualified.

GAAP Departure

An example of a report on additional information that is qualified because of a qualified opinion on the basic financial statements as a result of a departure from GAAP follows.

INDEPENDENT AUDITOR'S REPORT
ON ADDITIONAL INFORMATION

To ABC Company

Our report on our audit of the basic financial statements of ABC Company for 20X1 appears on page XX. That audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedules of investments (page X), property (page Y), and other assets (page Z) as of December 31, 20X1, are presented for purposes of additional analysis and are 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, except for the effects on the schedule of investments of not accounting for the investments in certain companies by the equity method[a] as explained in the third paragraph of our report on page XX,[b] such information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Notes:

[a] An auditor's report that is qualified because of a departure from GAAP should include the exception in a phrase such as "except for" or "with the exception of," and should briefly describe the departure. Note that the report on the additional information need not discuss the monetary effect of the departure.

[b] The auditor's report on the additional information is qualified for the same reason that the report on the basic financial statements was qualified. Therefore, the report on the additional information should refer to the paragraph of the report on the basic financial statements that describes the departure as prescribed in SAS No. 58 at AU 508.37–.38.

Scope Limitation

When the opinion on the basic financial statements has been qualified because of a restriction on the scope of the audit (whether imposed by the client or by the circumstances), and the restriction affects the additional information, the standard report on additional information should be modified as follows:

INDEPENDENT AUDITOR'S REPORT
ON ADDITIONAL INFORMATION

To ABC Company

Our report on our audit of the basic financial statements of ABC Company for 20X1 appears on page X. That audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedule of cost of goods sold on page Y is presented for purposes of additional analysis and is not a required part of the basic financial statements. Except as described in the following sentence, such information has been subjected to the auditing procedures applied in the audit of the basic financial statements. Our report on the basic financial statements explains that we were unable to observe the taking of the physical inventory of parts and accessories on December 31, 20X1, and we were unable to satisfy ourselves about inventory quantities by means of other auditing procedures. In our opinion, except for the effect of such adjustments, if any, as might have been determined to be necessary had we been able to observe the physical inventory of parts and accessories, the schedule of cost of goods sold is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Going Concern Uncertainty

Best practices indicate that when the auditor's report on the basic financial statements has been modified because of a going concern uncertainty and that uncertainty affects the additional information presented, the auditor's report on the additional information should refer to the uncertainty and should use unconditional language that includes the phrases "substantial doubt" and "going concern." In those circumstances, the standard report on additional information should be modified as follows:

INDEPENDENT AUDITOR'S REPORT
ON ADDITIONAL INFORMATION

To ABC Company

Our report on our audit of the basic financial statements of ABC Company for 20X1 appears on page X. That audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedule of other liabilities on page Y is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements, and in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole. Our report on the basic financial statements referred to factors that raise substantial doubt about the Company's ability to continue as a going concern. The schedule of other liabilities does not include any adjustments that might result from the outcome of this uncertainty.

Effect of Adverse Opinion or Disclaimer of Opinion on Basic Financial Statements

When auditors express an adverse opinion or disclaim an opinion on the basic financial statements, they should not express an opinion on any additional information. Expressing an opinion in those circumstances might tend to overshadow or contradict the adverse opinion or disclaimer of opinion on the basic financial statements. An example of a report on additional information when the auditor expressed an adverse opinion on the basic financial statements follows:

INDEPENDENT AUDITOR'S REPORT
ON ADDITIONAL INFORMATION

To ABC Company

Our report on our audit of the basic financial statements of ABC Company for 20X1 appears on page X. That audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The [identify information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements. For reasons stated in the third paragraph of our report on page X, we expressed an opinion that the basic financial statements of ABC Company do not fairly present financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America. Therefore, we do not express an opinion on the following additional information.

An example of a report on additional information when the auditor disclaimed on opinion on the basic financial statements follows:

INDEPENDENT AUDITOR'S REPORT
ON ADDITIONAL INFORMATION

To ABC Company

We were engaged to audit the basic financial statements of ABC Company for the purpose of forming an opinion on those statements taken as a whole. The [identify information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. As discussed in the second paragraph of our report on page X, the scope of our work was not sufficient to enable us to express an opinion on the basic financial statements presented therein. Similarly, we are unable to express, and do not express, an opinion on the following additional information.

Additional Data for Prior Years Related to Financial Statements Audited by Other Auditors

Occasionally, additional information will be presented for years in which the basic financial statements were audited by other auditors. The current auditors should state that the information for those years was subjected to auditing procedures by other auditors only if the report of the predecessor auditors included an opinion on that information. Any qualification contained in the predecessor auditor's report relating to the additional information should be disclosed in the successor auditor's report. If the predecessor auditor's report did not include an opinion on the additional information, that information should be clearly identified as unaudited, and the current auditors should disclaim an opinion on the information. The following is an example of a report on additional information when the basic financial statements for a prior year were audited by predecessor auditors whose report included an opinion on the information:

INDEPENDENT AUDITOR'S REPORT
ON ADDITIONAL INFORMATION

To ABC Company

Our report on our audit of the basic financial statements of ABC Company for 20X2 appears on page X. That audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The [identify information related to 20X2 financial statements] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements for the year ended December 31, 20X2, taken as a whole.

The basic financial statements of ABC Company for the year ended December 31, 20X1, presented on pages XX–YY, were audited by other auditors whose report dated March 1, 20X2, expressed an unqualified opinion on those financial statements. Their report, as of the same date, on [identify information related to the 20X1 financial statements] stated that, in their opinion, such information was fairly stated in all material respects in relation to the basic financial statements for the year ended December 31, 20X1, taken as a whole.

COMBINING OR CONSOLIDATING INFORMATION IN AUDITOR-SUBMITTED DOCUMENTS

Consolidating financial statements often are included as additional information supporting consolidated financial statements. It is appropriate for auditors to report on consolidating financial statements as additional information when such statements accompany consolidated financial statements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

26. Allison is looking for guidance on what information she is required to report on. In her workpapers, she has her client's basic financial statements and the documents that the auditors submitted to her clients. Which of the following authoritative literature should Allison consult when trying to determine her responsibility?

    a. SAS No. 8

    b. SAS No. 29.

    c. SAS No. 42.

    d. SAS No. 98.

27. Which of the following is correct regarding information to be included as part of the basic financial statements?

    a. Even if information is reported outside of the basic financial statements, the auditor has to include it in their standard report.

    b. Prospective financial statements, both current and expired, should be considered additional information, if they are presented with audited financial statements.

    c. If a detail of line items of the basic financial statements is included based on the client's request, then the detail should be presented on the face of the financial statements or in the accompanying notes.

    d. All additional information included with the basic financial statements should precede the financial statements and notes, so that they will not be missed by the reader.

28. Which of the following scenarios is an example of exception reporting?

    a. Jeanette is including with the basic financial statements an auditor-submitted document. She is disclosing that the auditor is responsible for the information in the document.

    b. Tony's client asks his auditors to include a detail of the line items in the asset section of the balance sheet. The auditor team agrees and includes in their auditor's report the degree of responsibility they have for the detailed information.

    c. Sarah, the auditor of ABC Company, has included supplementary information required by GAAP in a client-prepared document.

    d. Michael, the head of the audit team for Whiskey River Hats, has decided that the auditors are not going to comment on information in the financial statements as long as they do not disagree with the information, and the audit team feels no substantial doubts about the information.

29. The organizational data of a set of audited financial statements includes which of the following information?

    a. The classification of sales.

    b. List of stockholders.

    c. Schedule of equipment used in the plants.

    d. Status of tax returns.

30. Which of the following is true regarding the title on the auditor's standard report?

    a. Under SAS No. 58, the title on report on additional information should include the word "independent".

    b. SAS No. 58 does not require a title on the auditor's standard report.

    c. The description used on the report cover and table of contents does not have to conform to the title used in the description of the information since they are not located in the same place.

    d. In client-prepared documents, the term *additional information* should be used to distinguish the information supplementary information required by GAAP.

31. What is correct concerning the additional information included in an auditor's standard report?

    a. Additional information included in the auditor's scope will not change the auditor's opinion of the financial statements.

    b. Additional information is a required part of the basic financial statements for clarification for the reader.

    c. If additional information is included in the audit of the basic financial statements, an opinion should be formed based on the basic financial statements taken as a whole.

32. In which of the following scenarios would the auditor have to issue a disclaimer of opinion on the additional information or supplementary information that is accompanying the financial statements?

    a. Nick is applying all the same auditing procedures to the basic financial statements and the additional information in the auditor-submitted documents.

    b. Sarah has completed an audited set of financial statements. There is a specified element in the additional information included in the financial statements, so Sara has decided to issue a compilation, instead of issuing a disclaimer of opinion.

    c. The same basis of accounting was used on both the basic financial statement and the supplementary information for the audited financial statements.

    d. The audit team was asked to report on additional information relating period prior to those for which the basic financial statements are presented. The audit team applied the same audit procedures to all periods.

33. How should the additional information associated with basic financial statements from previous years that were audited by another auditor be presented?

    a. The current auditors should include a statement that references the predecessor auditors auditing procedures only if there was an adverse opinion on the previous audit.

    b. If the predecessor auditor qualified any information relating to the additional information in the previous audit, the successor auditor does not have to mention it in the current audit.

    c. If the predecessor auditor did not include an opinion on the additional information related to the basic financial statements in the previous years, the information should be clearly identified as unaudited.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

26. Allison is looking for guidance on what information she is required to report on. In her workpapers, she has her client's basic financial statements and the documents that the auditors submitted to her clients. Which of the following authoritative literature should Allison consult when trying to determine her responsibility? **(Page 173)**

    a. SAS No. 8. [This answer is incorrect. This Statement requires auditors to read "other information" in client-prepared annual reports and other documents containing financial statements on which they have reported and to consider (a) whether that information is materially inconsistent with information appearing in the financial statements and (b) whether it contains a material misstatement of fact.]

    b. SAS No. 29. [This answer is correct. Allison should refer to SAS No. 29 (AU 551), *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents,* for guidance on reporting on information in addition to a client's basic financial statements included in documents that auditors submit to clients and others.]

    c. SAS No. 42. [This answer is incorrect. This Statement establishes requirements for reporting on such information in client-prepared documents in a very narrow set of circumstances.]

    d. SAS No. 98. [This answer is incorrect. SAS No. 98 clarifies that auditors are allowed, but not required, to issue a report providing an opinion on required supplementary information that has been subjected to the auditing procedures applied in the audit of those basic financial statements.]

27. Which of the following is correct regarding information to be included as part of the basic financial statements? **(Page 175)**

    a. Even if information is reported outside of the basic financial statements, the auditor has to include it in their standard report. [This answer is incorrect. The auditor must report on it separately by either adding an additional paragraph to the standard report or issuing a separate report on such information because the information is deemed outside the basic statements, thus additional information.]

    b. Prospective financial statements should be considered additional information, if they are presented with audited financial statements. [This answer is incorrect. Prospective financial statements that are presented with audited financial statements should not be considered additional information for audit reporting purposes, and such information should be reported on in accordance with the AICPA's authoritative standard on prospective financial information.]

    c. If a detail of line items of the basic financial statements is included based on the client's request, then the detail should be presented on the face of the financial statements or in the accompanying notes. [This answer is correct. Schedules providing detail of line items in the financial statements should be considered additional information, but if the client wished to provide detail of line items in the basic financial statements and insists that the detail be part of the basic financial statements, the detail should be presented on the face of the financial statements or in the accompanying notes.]

    d. All additional information included with the basic financial statements should precede the financial statements and notes, so that they will not be missed by the reader. [This answer is incorrect. All additional information should be placed after the basic financial statements and notes and be preceded by a title page marked "ADDITIONAL INFORMATION".]

28. Which of the following scenarios is an example of exception reporting? **(Page 176)**

    a. Jeanette is including with the basic financial statements an auditor-submitted document. She is disclosing that the auditor is responsible for the information in the document. [This answer is incorrect. If the auditor includes an auditor-submitted document and the auditor's report discloses the responsibility assumed for the information outside the basic financial statements, then it is an example of explicit reporting.]

    b. Tony's client asks his auditors to include a detail of the line items in the asset section of the balance sheet. The auditor team agrees and includes in their auditor's report the degree of responsibility they have for the detailed information. [This answer is incorrect. Since Tony is including detailed line item information based on the client's request and the audit team includes the degree of responsibility they are assuming for the detail in their auditors' report, then the audit team is explicitly reporting, not exception reporting.]

    c. Sarah, the auditor of ABC Company, has included supplementary information required by GAAP in a client-prepared document. [This answer is incorrect. If the auditors include supplementary information required by GAAP in a client-prepared document, then it does not fit the criteria of exception reporting.]

    d. Michael, the head of the audit team for Whiskey River Hats, has decided that the auditors are not going to comment on information in the financial statements as long as they do not disagree with the information, and the audit team feels no substantial doubts about the information. [This answer is correct. Exception reporting is defined by the idea that auditors are silent with respect to the information in the financial statements unless (a) they disagree with the content of the information, (b) required information is omitted, (c) they are unable to perform prescribed procedures with respect to the information, or (d) they are unable to remove substantial doubts about whether the information conforms to prescribed guidelines.]

29. The organizational data included as additional information with audited financial statements include which of the following information? **(Page 177)**

    a. The classification of sales. [This answer is incorrect. The classification of sales is included in the results of operations category.]

    b. List of stockholders. [This answer is correct. The organizational data in auditor-submitted documents containing audited financial statements might include the list of stockholders if the company is a closely held corporation. Other items that could be included in the organizational data is the date of organization, duration of charter, location of principal plants and properties, the directors and officers, and subsidiaries of the company.]

    c. Schedule of equipment used in the plants. [This answer is incorrect. The property and equipment is included in the assets category.]

    d. Status of tax returns. [This answer is incorrect. The status of tax returns is included in the accounts payable and accrued expenses part of the liabilities category.]

30. Which of the following is true regarding the title on the auditor's standard report? **(Page 180)**

    a. Under SAS No. 58, the report on additional information should be titled. [This answer is correct. The report on additional information should be titled per SAS No. 58. Best practices indicate that the title should include the word "independent."]

    b. SAS No. 58 does not require a title on the auditor's standard report. [This answer is incorrect. SAS No. 29 does not require auditors to title their report on additional information; however SAS No. 58 does require a title for the auditor's standard report.]

    c. The description used on the report cover and table of contents does not have to conform to the title used in the description of the information since they are not located in the same place. [This answer is incorrect. All titles should match the description of the information used in the title to the description used on the report cover and in the table of contents. If a separator sheet using a descriptive title is used to separate the additional information from the basic financial statements, its title should conform too.]

d. In client-prepared documents, the term *additional information* should be used to distinguish the information from supplementary information required by GAAP. [This answer is incorrect. The term *additional information* should be used in auditor-submitted documents to distinguish the information from supplementary information required by GAAP. To some readers the term *supplementary information* implies it is needed or the basic financial statement would be incomplete.]

31. What is correct concerning the additional information included in an auditor's standard report? **(Page 181)**

a. Additional information included in the auditor's scope will not change the auditor's opinion of the financial statements. [This answer is incorrect. An audit of basic financial statements often encompasses the additional information and the auditor may choose to modify or redirect certain procedures applied in their audit of the basic financial statements so that they may form an opinion.]

b. Additional information is a required part of the basic financial statements for clarification for the reader. [This answer is incorrect. Additional information is presented for purposes of additional analysis and is not a required part of the basic financial statements.]

c. If additional information is included in the audit of the basic financial statements, an opinion should be formed based on the basic financial statements taken as a whole. [This answer is correct. An audit of basic financial statements often encompasses the additional information. The auditor's report on additional information should state that the audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole because the purpose of an audit in accordance with GAAS is to form an opinion on these statements taken as a whole.]

32. In which of the following scenarios would the auditor have to issue a disclaimer of opinion on the additional information or supplementary information that is accompanying the financial statements? **(Page 183)**

a. Nick is applying all the same auditing procedures to the basic financial statements and the additional information in the auditor-submitted documents. [This answer is incorrect. If the additional information in an auditor-submitted document is not subjected to auditing procedures in the audit of the basic financial statements, the auditors should disclaim an opinion on it. Since Nick applied the same procedures, he does not have to issue a disclaimer of opinion.]

b. Sarah has completed an audited set of financial statements. There is a specified element in the additional information included in the financial statements, so Sara has decided to issue a compilation, instead of issuing a disclaimer of opinion. [This answer is correct. A compilation report cannot be issued in lieu of a disclaimer when a specified element is present in the additional information accompanying the audited financial statements.

c. The same basis of accounting was used on both the basic financial statement and the supplementary information for the audited financial statements. [This answer is incorrect. A disclaimer of opinion should be issued on supplementary information that is not presented on the same basis of accounting as the basic financial statements. Since the same basis of accounting was used for both, a disclaimer of opinion should not be issued.]

d. The audit team was asked to report on additional information relating period prior to those for which the basic financial statements are presented. The audit team applied the same audit procedures to all periods. [This answer is incorrect. If the auditors have applied the same audit procedures to all periods, then a disclaimer of opinion does not have to be issued. If the auditors have not audited the basic financial statements for some of the years for which additional information is presented, then they should disclaim an opinion on the addition information for those years.]

33. How should the additional information associated with basic financial statements from previous years that were audited by another auditor be presented? **(Page 187)**

a. The current auditors should include a statement that references the predecessor auditors auditing procedures only if there was an adverse opinion on the previous audit. [This answer is incorrect. The current auditors should state that the information for those years was subjected to auditing procedures by other auditors if the report of the predecessor auditors included any opinion on that information.]

b. If the predecessor auditor qualified any information relating to the additional information in the previous audit, the successor auditor does not have to mention it in the current audit. [This answer is incorrect. Any qualification contained in the predecessor auditor's report relating to the additional information should be disclosed in the successor auditor's report.]

c. If the predecessor auditor did not include an opinion on the additional information related to the basic financial statements in the previous years, the information should be clearly identified as unaudited. [This answer is correct. If the predecessor auditor's report did not include an opinion on the additional information, that information should be clearly identified as unaudited and the current auditors should disclaim an opinion on the information so readers can clearly identify what information is audited and which information is not.]

AUDITOR-SUBMITTED DOCUMENTS CONTAINING NONACCOUNTING DATA

General

Additional information in an auditor-submitted document may consist of nonaccounting data and other information that is not susceptible to auditing procedures. SAS No. 29 at AU 551.03 clearly states that the auditors' reporting responsibilities also extend to "statistical data, and other material, some of which may be from sources outside the accounting system or outside the entity."

It is generally preferable to have such data prepared and submitted by the client separate from the auditor-submitted document. However, if the client insists that nonaccounting data be included in the auditor-submitted document, a disclaimer of opinion generally should be issued on the nonaccounting data.

The nonaccounting data should be presented in a separate section of the report and clearly identified with a title such as the following:

- Organizational Data
- Statistical Data
- Nonaccounting Information

If descriptive or explanatory comments accompany the nonaccounting information, they should be carefully worded to indicate that the auditors have not audited the data. That may be accomplished by using phrases such as the following:

- Obtained from company records
- Summarized from company statistics
- Shown by
- Furnished to us by

In addition, the nonaccounting data should be clearly marked "unaudited" or "not covered by auditor's report," or should include a reference to the auditors' disclaimer of opinion.

Disclaimer on Nonaccounting Data

An example of an auditors' disclaimer of opinion on nonaccounting data follows.

INDEPENDENT AUDITOR'S REPORT
ON ADDITIONAL INFORMATION

To ABC Company

Our report on our audit of the basic financial statements of ABC Company for 20X1 appears on page X. That audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The nonaccounting information shown on pages Y through Z[a] is presented for purposes of additional analysis and is not a required part of the basic financial statements. The nonaccounting information has not been subjected to the auditing procedures applied in the audit of the basic financial statements,[b] and, accordingly, we express no opinion on it.[c]

Notes:

[a] The information on which the auditors are disclaiming an opinion is clearly identified.

[b] The report states that the information was not subjected to the auditing procedures applied to the basic financial statements.

[c] The report states that the auditors express no opinion on the information.

The preceding report is an adaptation of the disclaimer prescribed by SAS No. 29 at AU 551.13.

Opinion on Additional Accounting Information, Disclaimer on Nonaccounting Data

When an auditor-submitted document contains both additional information on which the auditors can express an opinion and nonaccounting data, the auditors' disclaimer of opinion on the nonaccounting data should be clear so that the reader is not confused about which information is covered by the auditors' opinion and which is covered by the disclaimer. Such confusion may be avoided by using page numbers or other references. An example of such a report follows.

INDEPENDENT AUDITOR'S REPORT
ON ADDITIONAL INFORMATION

To ABC Company

Our report on our audit of the basic financial statements of ABC Company for 20X1 appears on page X. That audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The additional information in Schedules I, II, and III is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information in Schedules I and II 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. The information in Schedule III, which is of a nonaccounting nature, has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

AUDITOR-SUBMITTED DOCUMENTS CONTAINING CHARTS AND GRAPHS

Equipped with microcomputers capable of converting financial information to graphic presentations with the push of a button, many accountants have traded traditional numerical presentations for bar graphs and pie charts that depict a wide variety of supplementary information useful to their clients. Common examples include charts or graphs depicting—

- Number of days' sales in accounts receivable.
- Sales by product line.
- Operating expenses by plant.
- Line of credit usage versus owned inventory.

With those innovations, however, come questions regarding auditors' responsibilities for graphic presentations, since there are no authoritative standards that specifically address them. For example, should auditors report on such presentations when they accompany audited financial statements and, if so, what form should the report take?

When the basic financial statements are accompanied by information in the form of a chart or graph, best practices indicate such information should be considered supplementary information. Thus, the auditors always should report on such information when it is included in an auditor-submitted document.

How auditors report on a chart or graph, however, depends on the type of information that the chart or graph depicts. Specifically, is such information susceptible to the auditing procedures normally applied during an audit of the basic financial statements, or is it nonaccounting information that cannot be subjected to such procedures? If the chart or graph depicts information that may be subjected to auditing procedures, auditors should express an opinion on it using the form of report described previously. If the chart or graph depicts nonaccounting information, however, the auditors should disclaim an opinion on such information as described previously.

When an auditor-submitted document contains charts or graphs that depict both information on which auditors can express an opinion and nonaccounting information, the auditors' disclaimer of opinion on the chart or graph depicting the nonaccounting information should be clear so that users are not confused about which information is covered by the auditors' opinion and which is covered by the disclaimer.

Finally, best practices indicate that auditors should consider the following specific issues when reporting on a chart or graph that accompanies the basic financial statements:

- If the same information is presented numerically in the basic financial statements and graphically in the supplementary information, is such information consistent?
- Is the information presented in such a way that it is obviously misleading?
- Does the chart or graph include a reference to the auditor's report?

SUPPLEMENTARY INFORMATION THAT IS REQUIRED

General

GAAP requires certain entities to present supplementary information with their financial statements:

- The *FASB requires* publicly held companies to disclose supplementary information related to oil and gas producing activities. (See SFAS No. 69, *Disclosures about Oil and Gas Producing Activities*, Paragraphs 10–34 (FASB ASC 932-235-50-2).)
- SFAS No. 89, *Financial Reporting and Changing Prices* (FASB ASC 255), encourages, but *does not require*, companies to disclose supplementary information on the effects of changing prices. In addition, the AICPA Audit and Accounting Guide, *Audits of Common Realty Associations*, requires common interest realty associations (CIRAs) to present supplementary information about estimates of the remaining useful lives of common property components and estimates of current or future costs of major repairs and replacements. (Chapter 7 of the AICPA's CIRA guide describes the procedures that auditors should apply to the required supplementary information and discusses the auditors' reporting responsibility with respect to that information.)
- The *GASB requires* supplementary information regarding pensions. (In that case, however, SAS No. 29 at AU 551.15 states that the auditors should follow the guidance in SAS No. 42 at AU 552.)
- The *GASB requires* the following to be presented as supplementary information: management's discussion and analysis, budgetary comparison schedules (unless the government elects to include the required information in a budgetary comparison statement as part of the basic financial statements, rather than required supplementary information), infrastructure condition data (only if the government elects not to depreciate such assets), and risk and related insurance matters of public entity risk pools that issue separate financial reports.

The supplementary information is not necessary for a fair presentation of financial position and results of operations in conformity with GAAP. However, the standard-setting bodies requiring the information consider it to be an essential part of the financial reporting of those entities for which it is required.

The required supplementary information may be presented—

a. in a note to the financial statements, or

b. completely outside the financial statements.

Most auditors prefer that their clients present supplementary information outside the financial statements. However, some clients may choose to present the required supplementary information within the notes to the financial statements. If the information is included within the notes to the financial statements, it should be clearly labeled "unaudited" unless it is audited as part of the basic financial statements.

Auditors are required to apply certain limited procedures to the supplementary information. Those procedures are described in SAS No. 52 at AU 558.

Required Supplementary Information in an Auditor-submitted Document

When an auditor-submitted document includes required supplementary information, auditors should (a) express an opinion on the information if engaged to examine the information, (b) report on the information in relation to the financial statements taken as a whole using the guidance in AU 551.12 and 551.14, provided the information has been subjected to the auditing procedures applied in the audit of the basic financial statements, or (c) disclaim an opinion on the information.

An example of a disclaimer of opinion on supplementary information required by GAAP and presented outside the basic financial statements in an auditor-submitted document follows.

Required Supplementary Information in a Client-prepared Document

In a client-prepared document, SAS No. 52 at AU 558.08 prescribes exception reporting by auditors on the information if:

a. the required supplementary information is not presented,

b. the auditors conclude that the data is not prepared or presented in accordance with prescribed guidelines,

c. the auditors are unable to perform required procedures, or

d. the auditors are unable to resolve substantial doubts about whether the information conforms to prescribed guidelines.

When auditors conclude that they should report on the supplementary information presented in a client-prepared document because one of the circumstances above exists, they normally do so by adding an additional paragraph at the end of their standard reports. The supplementary information required by GAAP does not change the standards of financial accounting and reporting that apply to the client's basic financial statements. As a result, circumstances that may require auditors to report on the required supplementary information do not affect their opinion on the fairness of presentation of the financial statements in conformity with GAAP.

Some clients may choose to present the required supplementary information within the notes to the financial statements. If the information is included within the notes to the financial statements it should be clearly labeled "unaudited," unless it is audited as part of the basic financial statements. If required supplementary information within the notes is not labeled "unaudited," and is not audited as part of the basic financial statements, the auditor's report on the financial statements should be expanded to include a disclaimer on the information.

Voluntary Disclosure of Required Supplementary Information

Sometimes a company that is not required to present required supplementary information may voluntarily disclose such information. In those cases, if the information is presented in an auditor-submitted document, auditors should report on it. If the information is presented in a client-prepared document, auditors should apply the procedures and report on the information. Unless either (a) the company indicates that the auditors have not applied the procedures described in SAS No. 52 (AU 558) or (b) the auditors issue a disclaimer on the information such as the following:

> The [identify supplementary information] on page X is not a required part of the basic financial statements, and we did not audit or apply limited procedures to such information and do not express any assurance on such information.

However, if auditors do not apply the procedures described in SAS No. 52 (AU 558) to a voluntary presentation in a client-prepared document (even though they disclaim an opinion on the information), they should follow the requirements of SAS No. 8 at AU 550 for additional information included in client-prepared documents.

Voluntary Fair Value Disclosures

SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB ASC 825), requires disclosures, when practicable, of the fair value of financial instruments. SFAS No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities* (FASB ASC 825-10-50), makes those disclosures optional for companies that meet *all* of the following criteria:

- The company is a nonpublic company.
- The company has total assets of less than $100 million on the financial statement date.
- The company has no instrument that, in whole or in part, is accounted for as a derivative instrument under SFAS No. 133 (FASB ASC 815) during the reporting period.

If the company does not meet all of those criteria, SFAS No. 107 (FASB ASC 825) requires the following disclosures:

a. Fair value of financial instruments for which it is practicable to estimate fair value.

b. The methods and significant assumptions used to estimate fair value.

The required fair value disclosures generally are made in the notes to the audited financial statements.

Sometimes, clients may voluntarily present additional fair value disclosures (for example, the fair values of all material items in the balance sheet) in addition to the disclosures required by the Statement. In that case, the auditors' responsibilities for the voluntary fair value disclosures parallel those for supplementary information. The guidance below discusses the auditors' reporting responsibilities for voluntary fair value disclosures.

When the financial statements contain both required disclosures and voluntary fair value disclosures, the auditors' reporting responsibilities for the voluntary disclosures depend on (a) the way in which the voluntary disclosures are presented and (b) whether they have audited the voluntary information.

The auditors may audit the voluntary information only if both of the following conditions exist:

- The measurement and disclosure criteria used to prepare the fair value financial information are reasonable.
- Competent persons using the measurement and disclosure criteria would ordinarily obtain materially similar measurements or disclosures.

The intent of applying this guidance to the fair value information is to ensure that other auditors would reach similar conclusions regarding the reasonableness of the valuation or estimation techniques and methods used by the entity.

Voluntary disclosures may supplement any required disclosures in such a way as to constitute either a complete balance sheet (the fair value of all material items in the balance sheet) or a presentation of less than a complete balance sheet.

When the auditors have audited voluntary disclosures that do not constitute a complete balance sheet presentation, AU 9342.07 notes that the auditors' reporting responsibilities depend on how the disclosures are presented.

If the disclosures are located on the face of the financial statements or in the notes to the financial statements, they are considered part of the basic financial statements and the auditors need not specifically mention them in their report; that is, they may issue a standard unqualified opinion on the financial statements. If the disclosures are included in a supplemental schedule or exhibit, the auditors should report separately on such information as illustrated in AU 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*. As discussed previously, a separate report could be issued on the additional fair value information that would precede the schedule or exhibit. An example of such a report follows:

INDEPENDENT AUDITOR'S REPORT
ON ADDITIONAL INFORMATION

To ABC Company

Our report on our audit of the basic financial statements of ABC Company for 20X1 appears on page XX. That audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental fair value information presented in [describe where the information is presented, for example, Schedule I] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

In some cases, the auditors may be unable to audit the voluntary information because it does not meet both of the conditions above. In other situations, the auditors may not have not been engaged to audit the voluntary information. When unaudited voluntary information is included in an auditor-submitted document and is located on the face of the financial statements, in the notes to the financial statements, or in a supplemental schedule to the basic financial statements, the voluntary disclosures should be labelled "unaudited," and the auditors should disclaim an opinion on the unaudited information. If such information is presented in a supplemental schedule or exhibit, a separate disclaimer such as the following would be appropriate:

INDEPENDENT AUDITOR'S REPORT
ON ADDITIONAL INFORMATION

To ABC Company

Our report on our audit of the basic financial statements of ABC Company for 20X1 appears on page XX. That audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental fair value information presented in [describe where the information is presented, for example, Schedule I] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on it.

When the unaudited voluntary disclosures are included in a client-prepared document and are located on the face of the financial statements, in the notes to the financial statements, or in a supplemental schedule, they should be labelled "unaudited." When such unaudited voluntary information is presented elsewhere, the auditors should consider the guidance in AU 550, *Other Information in Documents Containing Audited Financial Statements*, which is discussed in the following section.

OTHER INFORMATION CONTAINED IN CLIENT-PREPARED DOCUMENTS

Client-prepared Annual Reports

SAS No. 8 (AU 550), *Other Information in Documents Containing Audited Financial Statements*, contains guidance for other information contained in (a) annual reports and (b) other documents to which the auditors, at the client's request, devote attention. SAS No. 8 clearly states that the auditors' responsibilities with respect to information in a client-prepared document containing audited financial statements does not extend beyond the financial information identified in their report and that the auditors have no obligation to perform any procedures to corroborate other information in such a document. However, auditors are required to read the other information and consider the manner in which it is presented to see whether it (a) is inconsistent with the information in the financial statements and (b) contains a material misstatement of fact. If the other information is not consistent with the financial statements, the auditors should take appropriate action. Such action might include:

a. requesting the client to revise the information to eliminate any material misstatement or inconsistencies,

b. including an explanatory paragraph in their report describing the inconsistency,

c. withholding use of their report in the document, or

d. withdrawing from the engagement.

Auditors' actions upon finding a material misstatement of fact depend on their judgment in the particular circumstances.

Inconsistency in Other Information

Clients rarely will refuse to revise the other information to eliminate an inconsistency. However, if that situation does occur and the auditors conclude, on the basis of the significance of the inconsistency, that their report should be expanded, they should add a paragraph describing the inconsistency following the opinion paragraph of their report. Neither the introductory, scope, nor opinion paragraphs of the auditor's report should refer to the inconsistency. The following is an example of an explanatory paragraph following the opinion paragraph that might be appropriate.

(after the opinion paragraph)

> The presentation of the loss from a plant closure in 20X1 included in the President's Letter on page X and in the Financial Highlights on page Y differs from the presentation of that loss in the statement of income referred to above, which is presented in conformity with accounting principles generally accepted in the United States of America.

Note that the above paragraph does not express or disclaim an opinion. It merely draws the reader's attention to the fact that certain information outside the basic financial statements is inconsistent with information in the financial statements, which are presented in conformity with GAAP.

Material Misstatement of Fact in Other Information

Occasionally, auditors find that the other information in a document containing the audited financial statements is not inconsistent with the financial statements but does contain a material misstatement of fact. (If the information is *both* inconsistent and a material misstatement, auditors should treat the matter as an inconsistency.

If the auditors conclude that (a) they have the ability to judge the accuracy of the information and (b) they have a valid basis for concern, they should discuss the matter with the client and propose that the client consult with someone, such as its legal counsel, who can give it useful advice. If, after discussing the matter with the client, the auditors still believe that the information includes a material misstatement of fact, their action depends on their judgment in the circumstances. They should consider notifying the client in writing of their concern and consulting their own legal counsel. In any case, they are not required to mention the matter in their report.

Other Client-prepared Documents That Contain Audited Financial Statements

SAS No. 8 (AU 550) primarily addresses situations where audited financial statements are combined by the client with other client-prepared information in an *annual report*. Very few nonpublic companies prepare annual reports; however, nonpublic companies frequently distribute copies of their audited financial statements, along with a variety of other client-prepared data, to banks, creditors, and others. Except for the guidance discussed below, authoritative literature does not address those situations, and, in reality, auditors have little control over or awareness of the client's actions once they deliver their report. As a precaution against possible misuse of the auditor's report after the financial statements are delivered to the client, most accounting firms type the financial statements and auditor's report on firm logo or watermark stationery and bind the product in a distinct report jacket that also contains the firm's name.

If auditors become aware that other information will likely be submitted with the audited financial statements to, for example, a bank to obtain financing, auditors have no responsibility under SAS No. 8 (AU 550) to "read" the other information *unless it will be physically bound with or attached to the audited financial statements*. A file folder that contains many separate and unattached client documents along with the auditor's report does not obligate the auditor to read the client documents, because they are clearly discernible as a work of the client. On the other hand, if the client intends to bind the auditor's report with other client-prepared information, the auditors should follow the guidance in SAS No. 8 even though the product may not be a formal annual report. Furthermore, if the other information to be bound with the financial statements is a forecast or projection, auditors should comply with the reporting guidance for prospective financial statements.

Reports by Management on the Effectiveness of an Entity's Internal Control over Financial Reporting. If a client-prepared document contains a separate report by management on the effectiveness of the entity's internal control over financial reporting (management's report) and the auditors have not been engaged to examine and report on it, they should follow the guidance in an auditing interpretation to SAS No. 8 at AU 9550.07–.11, *Reports by Management on Internal Control Over Financial Reporting*. Basically, that guidance states that the auditors have no obligation to perform any procedures to corroborate other information contained in such a document. They must, however, read the other information and consider whether it is materially inconsistent with other information appearing in the document, and, as a result, they may become aware of a material misstatement of fact.

If the auditors have not yet issued their report on the financial statements, they may (but are not required to) add an explanatory paragraph such as the following to their audit report:

> We were not engaged to examine management's assertion about the effectiveness of [name of entity]'s internal control over financial reporting as of [date] included in the accompanying [title of management's report], and, accordingly, we do not express an opinion thereon.

Other References by Management to Internal Control over Financial Reporting, Including References to the Independent Auditor. A client-prepared document also might contain other references by management to internal control, including a reference to the auditors. When the auditors have not been engaged to examine and report on management's assertion about the effectiveness of the entity's internal control over financial reporting, what are the auditors' responsibilities for such information?

The auditing interpretation to SAS No. 8 at AU 9550.07–.11 discussed above also contains guidance in those circumstances. Once again, the auditors have no obligation to perform any procedures to corroborate such other information. They must, however, read the other information and consider whether it is materially inconsistent with other information appearing in the document and, as a result, they may become aware of a material misstatement of fact.

When reading such other information, the auditors should look specifically to references made by management that deal with the auditors' consideration of internal control in planning and performing the audit. Some references might lead users to infer that the auditors performed more extensive procedures on internal control than they did or to believe that the auditors are giving assurances on the effectiveness of internal control. Similarly, the auditors should consider whether management's references might imply that the auditors' involvement was greater than is supported by the facts. If the auditors believe that management has misstated its involvement, they should consider such references a material misstatement of fact and follow the guidance discussed above.

In another situation, a client-prepared document might include, or refer to, a report from the auditors that communicates that they did not become aware of any material weaknesses in the entity's internal control during the audit. Auditors are permitted to report that to management. Such reports, however, are restricted to the use of management and others within the organization. (Auditors, however, are not permitted to communicate that there were no significant deficiencies noted during the audit.) An auditing interpretation at AU 9550.12–.15 notes that if management includes the report or refers to the report in a general use document, the auditors should remind management about the use restrictions. If management refuses to change its document to remove such references, the auditors should advise management that they do not consent to the use of their name in the document and consider what other actions might be appropriate. Legal counsel may be able to assist the auditors in deciding on the appropriate course of action in that circumstance.

Other Information Contained in IRS Form 5500

The Employee Retirement Income Security Act of 1974 requires employee benefit plans to report annually on IRS Form 5500. The AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*, notes that audited financial statements of employee benefit plans generally accompany the Form 5500 filed by the plan administrator. The Guide extends the auditor's responsibility under SAS No. 8 (AU 550) to the other information presented in Form 5500. Therefore, the Guide notes that auditors should read the other information in Form 5500 and consider whether such information or the manner of its presentation is materially inconsistent with the information, or the manner of its presentation, in the financial statements.

Other Information in Electronic Sites Containing Audited Financial Statements

When a company makes its audited financial statements (including the independent auditor's report) available in public computer networks such as the Internet, electronic bulletin boards, and similar venues, auditors may question their responsibility with respect to other information in those electronic sites. An auditing interpretation at AU 9550.16–.18, *Other Information in Electronic Sites Containing Audited Financial Statements*, clarifies the issue, noting that electronic sites are not "documents" as the term is used in SAS No. 8 (AU 550). Thus, auditors are not required to read information contained in the sites or consider the consistency of the other information in the sites with the original documents.

Auditors may be requested by their clients to provide other services with respect to information in electronic sites. The interpretation indicates that, in this situation, AU 550 does not apply. The auditor should refer to other auditing and attestation standards, for example, the auditor may refer to SSAE No. 10 (AT 201), *Agreed-Upon Procedures Engagements*.

REPORTING ON OTHER INFORMATION REQUESTED BY THE CLIENT

General

Despite the fact that auditors are not required to report on other information in client-prepared documents, clients often ask them to report on such information. SAS No. 98, *Omnibus Statement on Auditing Standards—2002*, amends SAS No. 8 to specifically allow auditors to report on other information based on the procedures they applied as part of their audit of basic financial statements. Accordingly, the other information to be reported on must relate to historical accounting data and auditors must be able to apply the auditing procedures they consider necessary. When reporting on other information in a client-prepared document, the auditor should follow the guidance in SAS No. 29 at AU 551.12 and 551.14.

Since auditors usually audit only the basic financial statements or may extend their audit to schedules or data supporting the statements if asked to do so, the auditor's report should be limited to such information. As a general rule, they should comment only with respect to information expressed in dollars, percentages derived from such dollar amounts, or quantitative information derived from accounting records that are part of the accounting system. Auditors should not comment on matters involving primarily the business judgment of the client, e.g., economic reasons for changes between periods in account balances or operations, matters that are not susceptible to the application of audit procedures, amounts that are not derived from accounting records, or other matters to which their competence as auditors is not relevant.

Other information that auditors frequently audit includes analyses of accounts, e.g., property and equipment and inventories; tables, charts, and graphs showing trends in selected financial data, e.g., net sales, net income, working capital, and property additions; and narrative discussions that include dollar amounts or percentages derived from audited financial statements.

Other information that auditors may cover in their report usually consists of condensed financial statements or selected financial data extracted from the financial statements or analyses of accounts or schedules supporting elements of the basic financial statements.

Analyses and Schedules

Clients often include additional schedules, analyses, exhibits, or statements in client-prepared documents containing audited financial statements. Authoritative literature does not require auditors to report on such data (unless it is inconsistent with information in the basic financial statements); however, clients often request auditors to express an opinion on the data.

Additional information that is not required for a fair presentation of financial position or results of operations in conformity with GAAP should be presented outside the basic financial statements and should not be referred to in the auditor's standard report. In addition, the auditors' opinion on such data should not be expressed in terms of fair presentation of financial position and results of operations in conformity with GAAP, but rather should be expressed in terms of presentation in relation to the financial statements taken as a whole.

When auditors are asked to report on additional analyses or schedules included in a client-prepared document, they generally do so by adding the following separate paragraph to their standard reports.

(after the opinion paragraph)

> Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information [schedules, exhibits] on pages XX to XX, inclusive,[a] is presented for purposes of additional analysis and is not a required part of the basic financial statements.[b] Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements[c] and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.[d]

Notes:

[a] When reporting on additional analyses or schedules, auditors should specifically identify the data covered by their report. A simple reference to page numbers is appropriate only when all data on the pages are covered.

[b] The report indicates that the analyses and schedules are not required for presentation of the basic financial statements in conformity with GAAP.

[c] The report states that the information has been audited as part of the audit of the basic financial statements in accordance with GAAS.

[d] The report states the auditors' opinion about whether the information is fairly stated in relation to the basic financial statements taken as a whole, rather than in conformity with GAAP.

If the other information is affected by a qualification in the auditor's report on the basic financial statements, the auditor's report on the other information also should be appropriately qualified. Following is an example of a separate paragraph auditors can add to their standard report when that report is qualified because of a departure from GAAP that affects the other information.

> Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information [schedules, exhibits] on pages XX to XX, inclusive, is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, except for the effects on the schedule of investments of not accounting for the investments in certain companies by the equity method as explained in the second preceding paragraph, such information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Unlike the case of reporting on additional information in an auditor-submitted document, the authors prefer to report on such information in a client-prepared document by using an additional paragraph after the auditors' standard opinion, rather than a separate opinion on a separate page. They believe that is preferable because in most client-prepared annual reports, the other information may precede or follow the basic financial statements and auditor's report and may be separated by many pages of narrative. Also, such data may be commingled with a long narrative. In other words, it is often difficult to find a convenient, nonconfusing place to present a separate report on other information in a client-prepared document. If the auditors desire to present a separate report, it should be drafted following the example in Exhibit 4-1.

REPORTING ON CONDENSED FINANCIAL STATEMENTS AND SELECTED FINANCIAL DATA

SAS No. 42

SAS No. 42 (AU 552), *Reporting on Condensed Financial Statements and Selected Financial Data*, provides guidance on reporting on the following information in client-prepared documents:

a. condensed financial statements (for either an interim or annual period) derived from audited financial statements of a public company that is required to file, at least annually, complete audited financial statements with a regulatory agency; and

b. selected financial data derived from audited financial statements of either a public or nonpublic company and presented in a document that includes audited financial statements (or, with respect to a public entity, that incorporates audited financial statements by referencing to information filed with a regulatory agency).

SAS No. 42 (AU 552) does not apply to condensed financial statements, selected financial statements, or selected financial data that accompany audited financial statements in auditor-submitted documents. Guidance for reporting on condensed financial statements and selected financial data that accompany audited financial statements in auditor-submitted documents is provided in SAS No. 29 (AU 551).

Condensed Financial Statements

SAS No. 42 (AU 552) defines condensed financial statements as financial statements presented in considerably less detail than complete financial statements that are intended to present financial position, results of operations, and cash flows. Condensed financial statements may simply be complete financial statements that omit notes or, more typically, financial statements that omit notes and combine statement components. Exhibit 4-2 describes various situations that an accountant of a nonpublic company may encounter in the area of condensed financial statements and provides reporting guidance.

Exhibit 4-2

Reporting on Condensed Financial Statements of a Nonpublic Company

Situation	Auditors' Responsibilities
<u>Case 1</u> A nonpublic company whose financial statements are audited presents condensed financial statements in a client-prepared document and (1) specifically names the auditor, (2) states that the condensed financial statements have been derived from audited financial statements, but (3) *excludes* the audited financial statements from the document.	SAS No. 42, at AU 552.07, footnote 6, indicates that the accountants would ordinarily express an adverse opinion on the condensed financial statements because of inadequate disclosure. **OR** A SSARS No. 1 compilation report for statements that omit substantially all disclosures may be issued if the condensed financial statements omit notes but do not combine statement components.
<u>Case 2</u> A nonpublic company whose financial statements are audited presents condensed financial statements in a client-prepared document but either (1) does *not* name the auditor or (2) does not state that the condensed financial statements have been derived from audited financial statements and *excludes* the audited financial statements from the document.	No action is required.
<u>Case 3</u> In either Case 1 or Case 2, the client-prepared document *includes* the audited complete financial statements.	SAS No. 8 (AU 550) would apply, and, accordingly, accountants should read the condensed financial statements and consider the manner in which they are presented to see that they are consistent with the audited complete financial statements. A separate report on the condensed financial information is not required unless the auditors deem it inconsistent. If requested to, the auditors may report on the condensed financial statements in accordance with SAS No. 42 (AU 552).
<u>Case 4</u> A nonpublic company whose financial statements have been audited presents condensed financial statements in a client-prepared document that (1) names the auditor, (2) states that the condensed financial statements have been derived from audited financial statements, and (3) incorporates the audited financial statements by reference and indicates where such statements and the auditor's report on them may be obtained.	A Technical Practice Aid at TIS 9080.15 states that many accountants believe that auditors need not report on condensed financial statements in that situation. If requested to report, auditors may issue an adverse opinion on the condensed financial statements as described in Case 1.

Situation	Auditors' Responsibilities
Case 5 Condensed financial statements are presented along with audited complete financial statements in an auditor-submitted document.	SAS No. 29 (AU 551) applies, and the condensed financial statements would be considered additional information. If the condensed financial statements are for periods prior to the accounting periods presented in the complete financial statements the auditors may give the same opinion on the data for earlier periods, if the auditor audited the prior periods.

*   *   *

The following is an example of an auditor's report appropriate for the situation in Case 1 in Exhibit 4-2.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the balance sheet of ABC Company (a Texas corporation) as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended (not presented herein).[a] These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

The condensed balance sheet as of December 31, 20X1, and the related condensed statements of income, retained earnings, and cash flows for the year then ended, presented on pages XX–YY, are presented as a summary and, therefore, do not include all of the information required by accounting principles generally accepted in the United States of America.[b]

In our opinion, because of the significance of the omission of the information referred to in the preceding paragraph, the condensed financial statements referred to above, do not present fairly,[c] in conformity with accounting principles generally accepted in the United States of America, the financial position of ABC Company as of December 31, 20X1, or the results of its operations or its cash flows for the year then ended.

Firm's signature

City, State

February 14, 20X2[d]

Notes:

[a] The introductory and scope paragraphs are similar to those paragraphs of the auditor's standard report, except that the introductory paragraph indicates that the complete audited financial statements are not included in the document.

b The report contains an additional paragraph explaining that the condensed financial statements are presented as a summary and do not include all disclosures required by generally accepted accounting principles. Neither the report nor the document containing it have to include the omitted disclosures, which is a departure from the usual requirement for an adverse opinion.

c The report expresses an adverse opinion because of the lack of required disclosures.

d The report should be dated as of the date of the report on the basic financial statements.

Selected Financial Data

SAS No. 42 (AU 552) also provides guidance for reporting on selected financial data included in a client-prepared document. That Statement requires auditors to disclaim an opinion on selected financial data if the client-prepared document in which the data appear (a) names the auditors and (b) states that the data were derived from audited financial statements but does not include the audited financial statements. The following is an example of a disclaimer of opinion appropriate in those circumstances:

> To ABC Company
>
> We did not audit the selected financial data on pages XX–YY, and, accordingly, we express no opinion on that information.

Selected financial data presented in auditor-submitted documents are considered to be additional information to be reported on in accordance with SAS No. 29 (AU 551).

Summary Information in Comparative Statements

SAS No. 58 (AU 508.65), footnote 24, states that continuing auditors need not report on summarized prior-period financial statements that are presented with the financial statements of the current period for comparative purposes. That situation often exists with entities that use fund accounting principles and present "total-all-funds" financial information for prior periods instead of financial data for each fund to avoid a cumbersome format. Also, nonprofit organizations frequently present certain prior-period information in total rather than by net asset class.

If the client requests that the auditors express an opinion on such summarized prior-period data, and the data does not contain sufficient details to constitute a fair presentation in conformity with GAAP, the additional details (such as detail by fund or net asset class) should be presented. Otherwise, the auditors should issue a qualified or adverse opinion.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

34. Zach is preparing an audit report. He is including graphs that he prepared for the client depicting operating expenses by plant and other nonaccounting data related to plant operations. What is Zach's responsibility regarding the graphical representations?

    a. Zach's graphs contain both information that an opinion can be expressed on and nonaccounting data that he will issue a disclaimer of opinion. He will make both of these items clear for the reader of the report.

    b. Although the graphs are considered supplementary information to the audit report, the auditor does not have to report on them.

    c. Since the graph depicts information that would be subjected to auditing procedures, Zach should disclaim an opinion to the graphical representation.

    d. There are specific authoritative standards that address charts and graphs in auditor-submitted documents that Zach could follow in determining his responsibility.

35. SAS No. 52 recommends exception reporting by an auditor on client-prepared documents if which of the following is present?

    a. The conclusion of the auditors is that the data is prepared and presented in accordance with suggested guidelines.

    b. All required procedures are able to be performed by the auditors.

    c. There is supplementary information present in the report.

    d. Substantial doubt is unable to be removed by the auditors about whether the information conforms to the prescribed guidelines.

36. When auditors determine that they need to report on the supplementary information presented in a client-prepared document due to the existence of one of several specified circumstances, they generally do so by:

    a. Modifying the last paragraph in their standard reports.

    b. Adding an additional paragraph at the end of their standard reports.

37. What is the auditor's accountability in regards to the disclosure of fair value?

    a. If the auditor audited a voluntary disclosure that did not constitute a complete balance sheet presentation and the disclosure is noted on the face of the financial statements, then the auditor must specifically mention it in the audit report.

    b. If the auditors were not engaged to audit the voluntary disclosure of fair value, but it is located on the face value of the financial statements, then it should be labeled "unaudited" and the auditors will not have to make any reference to an opinion on the information.

    c. The only requirement for auditor to audit voluntary disclosures of fair value is that an experienced person would acquire the comparison measurement and disclosure information.

    d. If the client voluntarily presents additional fair value disclosures, the auditor's responsibility for the fair value disclosure is the same as it would be for supplementary information.

38. If a client prepares a document and it contains references to the internal controls and the auditors, but the auditors were not engaged to examine the company's internal control structure, what is the auditors' responsibilities concerning this information?

    a. If a report was generated by the auditors concerning the internal control and that there were no material weaknesses noted in the entity's internal control during the audit, management can make reference to this information in their client-prepared document.

    b. The auditors have no responsibility to perform any procedures to confirm the information in the client's document, but they should read it and make sure it is materially consistent.

    c. The auditors are required to perform enough testing to be comfortable with the company's internal control system, so that the client may use the information.

    d. If the client's document might lead the reader to consider that management's references imply that the auditor's involvement was greater than is supported by facts, the auditor must decide if the references affect the report adversely.

39. For consolidated financial statements, which of the following would find authoritative guidance in SAS No. 29 instead of SAS No. 42?

    a. Public company condensed financial statements obtained from audited financial statements. The company files complete audited financial statements with a regulatory agency at least annually.

    b. Consolidated financial statements that accompany audited financial statements in an auditor-submitted document.

    c. Public or nonpublic company that has selected financial state derived from audited financial statements that are presented in a document that includes audited financial statements.

40. In which of the following situations would it require no action on the part of the auditor?

    a. A nonpublic company presents condensed financial statements in a client-prepared document but does not disclose that the condensed financial statements came from the audited financial statements nor who audited them. The company does not include the audited financial statements in the document.

    b. A nonpublic company includes audited financial statements in a client-prepared document and includes them in the document. The company also includes the name of the auditor in the document and states that the condensed financial statements have been taken from the audited financial statements.

    c. A nonpublic company with audited financial statements presents condensed financial statements in a client-prepared document and specifically names the auditor, states that the condensed financial statements came from the audited financial statements and excludes the audited financial statements from the document.

    d. Condensed financial statements and audited completed financial statements are presented in an auditor-submitted document.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

34. Zach is preparing an audit report. He is including graphs that he prepared for the client depicting operating expenses by plant and other nonaccounting data related to plant operations. What is Zach's responsibility regarding the graphical representations? **(Page 197)**

    a. Zach's graphs contain both information that an opinion can be expressed on and nonaccounting data that he will issue a disclaimer of opinion. He will make both of these items clear for the reader of the report. [This answer is correct. When an auditor-submitted document contains charts or graphs that depict both information on which auditors can express an opinion and nonaccounting information, the auditors' disclaimer of opinion on the chart or graph depicting the nonaccounting information should be clear so that users are not confused about which information is covered by the auditor's opinion and which is covered by the disclaimer of opinion.]

    b. Although the graphs are considered supplementary information to the audit report, the auditor does not have to report on them. [This answer is incorrect. Graphs are considered supplementary information and should be reported on because, auditors should report on such information when it is included in an auditor-submitted document.]

    c. Since the graph depicts information that would be subjected to auditing procedures, Zach should disclaim an opinion to the graphical representation. [This answer is incorrect. If a chart or graph depicts information that may be subjected to auditing procedures, the auditor should express an opinion on the information and not issue a disclaimer.]

    d. There is specific authoritative standards that address charts and graphs in auditor-submitted documents that Zach could follow in determining his responsibility. [This answer is incorrect. There is no authoritative standards that specifically address graphical presentations due to these innovations being fairly new.]

35. SAS No. 52 recommends exception reporting by an auditor on client-prepared documents if which of the following is present? **(Page 198)**

    a. The conclusion of the auditors is that the data is prepared and presented in accordance with suggested guidelines. [This answer is incorrect. Exception reporting is advocated by SAS No. 52 when the auditors conclude that the data is not prepared or presented in accordance with prescribed guidelines. When reporting a material departure from the prescribed guidelines, the auditors should add a paragraph to their report identifying the supplementary information out of conformance with guidelines.]

    b. All required procedures are able to be performed by the auditors. [This answer is incorrect. Exception reporting is recommended by SAS No. 52 at AU 558.08 when the auditors are unable to perform required procedures. Auditors should add a paragraph after the opinion paragraph describing the reasons they were unable to apply certain procedures prescribed by professional standards.]

    c. There is supplementary information present in the report. [This answer is incorrect. Exception reporting is advised when the required supplementary information is not presented per SAS No. 52 at AU 558.08. Auditors should include an additional paragraph after the opinion paragraph describing the supplementary information required and who required it.]

    d. Substantial doubt is unable to be removed by the auditors about whether the information conforms to the prescribed guidelines. [This answer is correct. According to SAS No. 52 at AU 558.08, exception reporting is prescribed when the auditors are unable to resolved substantial doubts about whether the information conforms to prescribed guidelines. Auditors should add a paragraph stating the doubts were unresolved. Auditors should consider including the reasons why they were unable to resolve their doubts.]

36. When auditors determine that they need to report on the supplementary information presented in a client-prepared document due to the existence of one of several specified circumstances, they generally do so by: **(Page 198)**

    a. Modifying the last paragraph in their standard reports. [This answer is incorrect. Auditors should not modify the last paragraph of their standard reports when there is a need to report on the supplementary information presented in a client-prepared document, but rather, add an additional paragraph to the end of their standard reports addressing that information.]

    b. Adding an additional paragraph at the end of their standard reports. [This answer is correct. Auditors that need to report on the supplementary information presented in a client-prepared document due to the existence of specified circumstances, should do so in an additional paragraph at the end of their standard reports. By using an additional paragraph, the information is highlighted and reported on separately from other information in the reports.]

37. What is the auditor's accountability in regards to the disclosure of fair value? **(Page 199)**

    a. If the auditor audited a voluntary disclosure that did not constitute a complete balance sheet presentation and the disclosure is noted on the face of the financial statements, then the auditor must specifically mention it in the audit report. [This answer is incorrect. When auditors have audited voluntary disclosures that do not constitute a complete balance sheet presentation, AU 9342.07 notes that the auditor's reporting responsibility depends on how the disclosures are presented. If they are located on the face of the financial statements the auditor need not specifically mention them in their report.]

    b. If the auditors were not engaged to audit the voluntary disclosure of fair value, but it is located on the face value of the financial statements, then it should be labeled "unaudited" and the auditors will not have to make any reference to an opinion on the information. [This answer is incorrect. When unaudited voluntary information is included in an auditor-submitted document and is located on the face of the financial statements, the voluntary disclosures should be labeled "unaudited" and the auditors should disclaim an opinion on the unaudited information.]

    c. The only requirement for the auditor to audit the voluntary disclosures of fair value is that an experienced person would ordinarily acquire the comparison measurement and disclosure information. [This answer is incorrect. While this is one of the criteria for an auditor to audit voluntary disclosures of fair value information, there is also a second criterion. The measurement and disclosure criteria used to prepare the fair value financial information are reasonable. Both conditions must exist for the auditor to audit the voluntary information.]

    d. If the client voluntarily presents additional fair value disclosures, the auditor's responsibility for the fair value disclosure is the same as it would be for supplementary information. [This answer is correct. Sometimes, clients may voluntarily present additional fair value disclosures. In that case, the auditor's responsibility for the voluntary fair value disclosure parallels those for supplementary information and depends on (a) the way in which the voluntary disclosures are presented and (b) whether they have audited the voluntary information.]

38. If a client prepares a document and it contains references to the internal controls and the auditors, but the auditors were not engaged to examine the company's internal control structure, what are the auditors' responsibilities concerning this information? **(Page 202)**

    a. If a report was generated by the auditors communicating that there were no material weaknesses noted in the entity's internal control during the audit, management can make reference to this information in their client-prepared document. [This answer is incorrect. Reports such as these are restricted to the use of management and others within the organization. If management refuses to remove these references from their document, the auditors should advice management that they do not consent to the use of their name in the document and consider what other actions might be appropriate, including seeking legal counsel.]

b. The auditors have no responsibility to perform any procedures to confirm the information in the client's document, but they should read it and make sure it is materially consistent. [This answer is correct. Auditors have no obligation to perform any procedures to corroborate the client's document. The auditors must to read the other information and consider whether it is materially inconsistent with other information that appears in the document that could lead to a material misstatement of fact.]

c. The auditors are required to perform enough testing to be comfortable with the company's internal control system, so that the client may use the information. [This answer is incorrect. Auditors have no obligation to perform any procedures to corroborate the client's document. If the auditors have not yet issued their report on the financial statements, they may want to add an explanatory paragraph in their audit report.]

d. If the client's document might lead the reader to consider that management's references imply that the auditor's involvement was greater than is supported by facts, the auditor must decide if the references affects the report adversely. [This answer is incorrect. In this case, the auditor should consider these types of references in the client document a material misstatement of fact and consider notifying the client in writing of their concern.]

39. For condensed financial statements, which of the following would find authoritative guidance in SAS No. 29 instead of SAS No. 42? **(Page 205)**

a. Public company's condensed financial statements obtained from audited financial statements. The company files complete audited financial statements with a regulatory agency at least annually. [This answer is incorrect. SAS No. 42 provides guidance on reporting in client-prepared documents for condensed financial statements (for either an interim or annual period) derived from audited financial statements of a public company that is required to file, at least annually, complete audited financial statements with a regulatory agency.]

b. Condensed financial statements that accompany audited financial statements in an auditor-submitted document. [This answer is correct. SAS No. 42 does not apply to condensed financial statements, selected financial statements, or selected financial data that accompanies audited financial statements in auditor submitted documents. This guidance is provided in SAS No. 29.]

c. Public or nonpublic company's selected financial data derived from audited financial statements that are presented in a document that includes audited financial statements. [This answer is incorrect. SAS No. 42 offers guidance on reporting of selected financial data derived from audited financial statements of either a public or nonpublic company and presented in a document that includes audited financial statements (or, with respect to a public entity, that incorporates audited financial statements by referencing to information filed with a regulatory agency.]

40. In which of the following situations would no action be required of the auditor? **(Exhibit Page 206)**

a. A nonpublic company presents condensed financial statements in a client-prepared document but does not disclose that the condensed financial statements came from the audited financial statements nor who audited them. The company does not include the audited financial statements in the document. [This answer is correct. If a nonpublic company whose financial statements are audited presents condensed financial statements in a client-prepared document but either (1) does not name the auditor or (2) does not state that the condensed financial statements have been derived from the audited financial statements and excludes the audited financial statements from the document, the auditor has no responsibility for the condensed financial statements in the client-prepared document.]

b. A nonpublic company includes audited financial statements in a client-prepared document and includes them in the document. The company also includes the name of the auditor in the document and states that the condensed financial statements have been taken from the audited financial statements. [This answer is incorrect. If a nonpublic company, that has audited financial statements, uses the financial statements to produce condensed financial statements in a client-prepared document and names the auditor, states that the information came from the audited financial statements, and includes the audited financial statements, then SAS No. 8 applies. The auditor should read the condensed financial statements and consider the manner in which they are presented to see that they are consistent with the audited complete financial statements.]

c. A nonpublic company with audited financial statements presents condensed financial statements in a client-prepared document and specifically names the auditor, states that the condensed financial statements came from the audited financial statements and excludes the audited financial statements from the document. [This answer is incorrect. If a nonpublic company whose financial statement are audited presents condensed financial statements in a client-prepared document and specifically names the auditor, states that the condensed financial statements have been derived from the audited statements and excludes the audited financial statements from the document, the auditor would normally express an adverse opinion on the condensed financial statements because of inadequate disclosures based on SAS No. 42.]

d. Condensed financial statements and audited complete financial statements are presented in an auditor-submitted document. [This answer is incorrect. If condensed financial statements are presented along with audited complete financial statements in an auditor-submitted document, then the auditor should apply SAS No. 29 and the condensed financial statements should be considered additional information.]

EXAMINATION FOR CPE CREDIT

Lesson 4 (GARTG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

26. According to SAS No. 52, *Omnibus Statement on Auditing Standards—1987,* when does an auditor have a responsibility to report on supplementary information required by GAAP?

    a. When the auditors complete the prescribed procedures.

    b. When the auditors have eliminated all doubt about whether the supplementary information conforms to the prescribed guidelines.

    c. When the required information is included in the supplement.

    d. When the presentation of the information in the supplement departs materially from the prescribed guidelines, based on the auditors conclusion.

27. Which of the following would be considered part of the basic financial statements?

    (i) Internal control policies.

    (ii) Income statement.

    (iii) Depreciation schedules.

    (iv) Balance sheet.

    (v) Statement of cash flows.

    (vi) Statement of completed contracts.

    (vii) Statement of retained earnings.

    a. i, iii, v, vii.

    b. ii, iii, v, vi.

    c. ii, iv, v, vii.

    d. iii, iv, v, vi, vii.

28. Which of the following statements concerning Evan's auditor-submitted documents is most accurate?

    a. Evan must disclaim an opinion on any additional information not covered by the audit and indicate the responsibility taken for information that he has audited.

    b. Evan's reporting responsibilities in his auditor-submitted documents do not differ from his responsibilities for information in a client-prepared document

    c. Evan's documents should be bound in the firm's report cover and printed on paper bearing the client's logo or watermark.

    d. No disclaimer of opinion is necessary because, Evan wants readers to assume that he takes some degree of responsibility for all the information in the document,

29. Once the client has paid for the audit and received the audited financial statements, the client may separate the financial statements in any way that would serve their purpose.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

30. A notes receivable list could be included as additional information in auditor-submitted documents containing audited financial statements. In which category is this item included?

    a. Assets.

    b. Liabilities.

    c. Results of Operations.

    d. Organizational Data.

31. An auditor can express an opinion on a portion of the accompanying information and disclaim an opinion on another portion.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

32. Which of the following is accurate regarding the auditor's report on additional information?

    a. Don't repeat the signature and location on the additional information report as it was already included in the basic financial statements report.

    b. If an adverse opinion is expressed on the basic financial statements, then an adverse opinion should be expressed on the accompanying information, too.

    c. The basic financial statements report and the auditor's report on additional information should have the same date.

    d. If an auditor is reporting on additional information that is historical, in addition to data in years covered by the basic financial statements, then an opinion must be given on each year that is included in the report.

33. In which of the following situations should the auditor **not** express an opinion on any additional information?

    a. If the auditors express an adverse opinion on the basic financial statements.

    b. The basic financial statements have a qualified opinion resulting from a departure from GAAP.

    c. If the basic financial statements have been modified due to a going concern and that concern affects the additional information.

    d. The basic financial statements have a qualified opinion due to a scope limitation on the audit.

34. Which of the following is **not** a title that could be used for the separate section of the audit report for nonaccounting data?

    a. Organizational Data.

    b. Report on Other Information.

    c. Nonaccounting Information.

    d. Statistical Data.

35. Regarding supplementary information, information related to what type of activity is required to be disclosed by publicly held companies by FASB?

    a. Pensions.

    b. Risk and related insurance matters of public entity risk pools issuing separate reports.

    c. Estimated useful lives of common property for CIRAs.

    d. Oil and gas producing activities.

36. Travis has an auditor-submitted document that contains required supplementary information. Which of the following is **not** a choice of how Travis can deal with this information in his audit report?

    a. Report on the supplemental information using guidance AU 551.12 and 551. 14.

    b. Not address the supplemental information since it is not part of the basic financial statements.

    c. Express an opinion on the supplementary information, if included in the scope of the engagement.

    d. Disclaim an opinion on the supplemental information.

37. Disclosures about the fair value of financial instruments can be optional for companies that meet all of three criteria. Which of the following is one of those criteria?

    a. The total assets of the company is more than $100 million on the financial statement date.

    b. The company is a public company.

    c. None of the instruments of the company is accounted for as a derivative instrument under SFAS No. 133 during the reporting period.

    d. Do not select this answer choice.

38. Sean is the audit team leader on the audit for Zip Zap Company. His responsibility in relation to the client-prepared documents containing audited financial statement does not extend beyond the financial information identified in their report. He is required to read the other information and consider the manner in which it is presented. If the material is not consistent with the financial statements, Sean should take appropriate action. Which of the following is **not** one of the action items that Sean could decide in this situation?

    a. Because the inconsistency is not material, Sean could allow Zip Zap Company to use the financial information in their document without requesting a change to the information.

    b. Sean could include an explanatory paragraph in the Zip Zap Company's document, describing the inconsistency.

c. Sean could withdraw from the engagement, if Zip Zap Company is unwilling to make the change to their document.

d. Sean could disallow Zip Zap from using the audited financial information in their document.

39. When does an auditor have a responsibility to read client documents that will be submitted with audited financial statements for other uses?

    a. If the audited financial statements are placed in a file folder with the client documents for submission to a third party.

    b. The auditor has no control over a client's actions once they deliver their report, so they have no responsibility to read client documents.

    c. If the audited financial statements are going to be physically bound or attached to the client documents.

    d. Do not select this answer choice.

40. Auditors usually only audit basic financial statements, schedules or data supporting statements and the auditor's report should be limited to such information. Which of the following is information that an auditor should comment on in their audit report?

    a. Information involving the business judgment of the client.

    b. Information, quantitative in nature, derived from accounting records.

    c. Information that is not disposed to the application of auditing procedures.

    d. Information where competence as auditors is not relevant.

GLOSSARY

Adverse opinion: An accountant's opinion concerning financial statements, that the statements are not in conformity with GAAP and/or that they do not present results fairly.

AICPA: American Institute of Certified Public Accountants.

Consistency standard: Using the same accounting procedures by an accounting entity from period to period.

Disclaimer of opinion: A circumstance when an accountant or other professional refuses to express an opinion.

Disclosure: The release by companies of all information, positive or negative, that might bear on an investment decision, as required by the Securities and Exchange Commission and the stock exchanges.

Emphasis of a matter (EOM) paragraph: A paragraph in the auditor's report used to emphasize a matter regarding the financial statements.

FASB: Financial Accounting Standards Board. A private, not-for-profit organization whose primary purpose is to develop generally accepted accounting principles (GAAP) within the United States in the public's interest.

GAAP: Generally Accepted Accounting Principles. The term used to refer to the standard framework of guidelines for financial accounting used in any given jurisdiction. GAAP includes the standards, conventions, and rules accountants follow in recording and summarizing transactions, and in the preparation of financial statements

Going concern uncertainty: A type of uncertainty that may arise when a company is unable to meet its obligations as they come due without substantial disposal of assets outside of the ordinary course of business, restructuring of its debt, externally forced revisions of its operations, or similar actions.

Management representation letter: A letter addressed to the auditor that has been drafted by the auditor and given to the client's senior management to sign. The principle reasons for such a letter include the minimization of misunderstandings between the client's management and the auditor, and the commitment to the writing of representations previously made verbally by management to the auditor.

Material weakness: A significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

Monitoring: A process that assesses the quality of internal control performance over time.

NASBA: National Association of State Boards of Accountancy.

Qualified opinion: Language in the auditor's opinion accompanying financial statements that calls attention to limitations of the audit or exceptions the auditor takes to items in the statements. Typical reasons for qualified opinions: pending lawsuit that, if lost, would materially affect the financial condition of the company; indeterminable tax liability relating to an unusual transaction; inability to confirm a portion of the inventory because of inaccessible location.

Risk assessment: The entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.

Scope limitation: May include client-imposed restrictions upon the audit, restrictions beyond the client's control, or the existence of other conditions precluding necessary auditing procedures.

Split-level reporting: The expression of an audit opinion on one of the basic financial statements, and a disclaimer of opinion on the other basic financial statement.

Unqualified opinion: An unqualified opinion is an auditor's opinion of a financial statement, given without any reservations. Such an opinion basically states that the auditor feels the company followed all accounting rules appropriately and that the financial reports are an accurate representation of the company's financial condition.

INDEX

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COMPANION TO PPC'S GUIDE TO AUDITOR'S REPORTS

COURSE 3

Special Reports (GARTG093)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course covers a variety of special reporting situations including financial statements prepared in conformity with other comprehensive bases of accounting (OCBOA), specified elements, accounts or items of a financial statement, compliance issues, and prescribed forms. Other issues covered include reporting on companies in insolvency and bankruptcy proceedings, application of accounting principles, reporting on applying agreed-upon procedures, as well as consulting engagements, among others. This course also addresses attestation standards.
PUBLICATION/REVISION DATE:	October 2009
RECOMMENDED FOR:	Users of *PPC's Guide to Auditor's Reports*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of auditing
CPE CREDIT:	6 QAS Hours, 6 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
FIELD OF STUDY:	Auditing
EXPIRATION DATE:	Postmark by **October 31, 2010**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Reports on Financial Statements Prepared in Conformity with OCBOA and Other Types of Reports

Completion of this lesson will enable you to:
- Identify reports on financial statements prepared in conformity with OCBOA including specific reports on the regulatory, income tax, and cash bases of accounting.
- Discuss reporting on other special-purpose financial statements and other special reporting topics.

Lesson 2—Other Special Reporting Areas

Completion of this lesson will enable you to:
- Describe attestation standards including report illustrations and modifications.
- Describe reporting on applying agreed-upon procedures, prospective financial information, and pro forma information.
- Discuss compliance with requirements of laws, regulations, or rules and how they are applied.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
Tax & Accounting—R&G
GARTG093 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Reports on Financial Statements Prepared in Conformity with OCBOA and Other Types of Reports

INTRODUCTION

This course covers a wide range of special reporting situations including financial statements prepared in conformity with OCBOA.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify reports on financial statements prepared in conformity with OCBOA including specific reports on the regulatory, income tax, and cash bases of accounting.
- Discuss reporting on other special-purpose financial statements and other special reporting topics.

BACKGROUND INFORMATION

Scope of Lesson

The term *special reports*, as used in this course, refers to the following reporting situations:

- Financial statements prepared on comprehensive bases of accounting other than generally accepted accounting principles
- Specified elements, accounts, or items of a financial statement
- Compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements
- Special-purpose financial presentations to comply with contractual agreements or regulatory requirements
- Financial information presented in prescribed forms or schedules
- Companies in insolvency and bankruptcy proceedings
- Reporting on solvency
- Application of accounting principles
- Pro forma financial information
- Prospective financial information
- Consulting engagements
- Any engagement to issue an examination, review, or agreed-upon procedures report on subject matter, or an assertion about the subject matter, that is the responsibility of another party (attest engagements)

Note that the term *special reports* does not apply to reports on reviews of interim financial information.

Proposed SASs That Would Amend Auditing Standards on Special Reports

The Auditing Standards Board has voted to issue the following two exposure drafts of proposed SASs that would supersede AU 623:

- *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks,* which would supersede portions of AU 623 that address auditor's reports on (a) financial statements that are prepared in conformity with a comprehensive basis of accounting other than GAAP, (b) financial presentations to comply with contractual agreements or regulatory requirements, and (c) financial information presented in prescribed forms or schedules that require a prescribed form of auditor's report.

- *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement,* which would supersede portions of AU 623 that apply to auditor's reports on specified elements, accounts, or items of a financial statement.

The proposed SASs indicate that they will be effective no earlier than for audits for periods beginning on or after December 15, 2010.

The following paragraphs summarize relevant provisions of the exposure drafts and highlight aspects that differ from existing standards for special reports.

Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks. The proposed SAS defines a "special purpose framework" as a financial reporting framework other than GAAP that is either cash basis, tax basis, regulatory basis, or contractual basis. The definitions of those bases are consistent with existing auditing standards. The proposed SAS states that "the cash, tax, and regulatory bases of accounting are commonly referred to as "other comprehensive bases of accounting." Unlike existing literature, the proposed SAS does not define "other comprehensive bases of accounting" and, thus, limits its applicability to the three OCBOAs specifically cited (i.e., the cash, tax, and regulatory bases). Accordingly, the proposed SAS does not address accounting bases that are "other definite sets of criteria having substantial support," such as current value or liquidation accounting.

The auditor's reporting responsibilities in the proposed SAS are essentially consistent with the guidance in the existing SASs. Accordingly, the proposed SAS requires the auditor to evaluate whether the financial statements (a) are suitably titled, (b) include a summary of significant accounting policies, and (c) adequately describe how the special purpose framework differs from GAAP. (The effect of the differences need not be quantified.) If the financial statements are prepared in accordance with contractual provisions, the auditor also is required to evaluate whether financial statements adequately describe any significant interpretations of the contract. The proposed SAS imposes a new requirement for auditors to obtain management's acknowledgement of its responsibility to include all disclosures that are appropriate for the framework of accounting used to prepare the financial statements.

Consistent with existing standards, auditor's reports on cash and tax basis financial statements and on financial statements prepared in conformity with contractual provisions should include a separate paragraph to inform users that the special purpose framework is other than GAAP and refers to the note to the financial statements that describes that framework. In addition to the preceding requirements, auditor's reports on financial statements presented on a basis of accounting that complies with contractual or regulatory provisions should describe the special purpose for which the statements are prepared or refer to a note to the financial statements that includes that information. A new requirement in the proposed SAS would require, in those cases when management can choose the financial reporting framework on which the financial statements are prepared (which often would be the case when the financial statements are presented on either the cash or tax basis), that the statement in the auditor's report of management's responsibility for the financial statements also state its responsibility for determining that the reporting framework is acceptable in the circumstances.

Auditor's reports on financial statements prepared in conformity with regulatory provisions are, in most respects, consistent with existing standards. However, when regulatory basis financial statements are intended for general use, the proposed SAS does not require the auditor's report to include a separate paragraph to inform users that the special purpose framework is other than GAAP because, in those cases, the auditor expresses an opinion both on conformity with the regulatory basis and on conformity with GAAP.

With respect to auditor's reports on financial statements included in prescribed forms, the proposed SAS would carry forward the guidance in the existing literature that when the prescribed report form is not acceptable because it calls for auditor assertions for which the auditor has no basis, the auditor is required to reword the prescribed report form or attach an appropriately worded separate report. In addition, the proposed SAS states that the auditor's report should refer to GAAS only if it includes the following elements:

- A title.
- An addressee.
- A paragraph that identifies the special purpose financial statements audited.
- A description of management's responsibility for the financial statements.
- A description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit that includes a (a) reference to GAAS and the law or regulation and (b) description of an audit in accordance with those standards.
- An opinion on the financial statements and a reference to the special purpose framework used to prepare the financial statements.
- The auditor's signature and address.
- The date of the auditor's report.

Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement. The proposed SAS carries forward, in most respects, the guidance in existing auditing standards that applies to audits of elements, accounts, or items of a financial statement, but also extends that guidance to an audit of a single financial statement, including the related notes. However, the proposed SAS modifies the existing requirement that auditors must audit the related financial statements to have a basis for expressing an opinion on certain financial statement elements that are based on net income or stockholders' equity (or equivalent). Instead, when the auditor is not also engaged to audit the complete financial statements, the proposed SAS requires the auditor to perform procedures on interrelated items to obtain sufficient appropriate audit evidence to enable the auditor to express an opinion about the financial condition or the results of operations and cash flows.

The proposed SAS also essentially carries forward the reporting guidance in the existing standards. It also provides reporting guidance when the audit of a single financial statement is performed in conjunction with an audit of the complete financial statements. The proposed SAS states that when auditors express an adverse opinion or disclaim an opinion on the complete financial statements, auditors are precluded from issuing an unmodified opinion on a single financial statement because the single financial statement is considered to constitute a major portion of the financial statements.

REPORTING ON OCBOA FINANCIAL STATEMENTS

What Is an OCBOA?

The term *OCBOA* is an acronym for an other comprehensive basis of accounting, i.e., a comprehensive basis of accounting other than generally accepted accounting principles. To be considered an OCBOA, a basis of accounting must meet one of the following criteria:

- A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a government regulatory agency to whose jurisdiction the entity is subject.
- A basis of accounting that the entity uses or expects to use to file its income tax return for the period covered by the financial statements.
- The cash receipts and disbursements basis of accounting and modifications of the cash basis having substantial support, such as recording depreciation on fixed assets or accruing income taxes.

- A definite set of criteria having substantial support that is applied to all material items appearing in the financial statements, such as the price-level basis of accounting.

Financial statements prepared in conformity with international financial reporting standards (IFRS) as issued by the International Accounting Standards Board (IASB) are not considered to be OCBOA financial statements to be reported on under SAS No. 62 (AU 623). Also financial statements of a U.S. company prepared in conformity with accounting principles generally accepted in another country are *not* considered OCBOA financial statements to be reported on under SAS No. 62 (AU 623). Instead, the reporting standards in SAS No. 51 (AU 534), *Reporting on Financial Statements Prepared for Use in Other Countries*, apply.

The four criteria listed above represent the authoritative definition of OCBOA. However, some auditors believe that those distinctions are too vague. It is difficult in some situations to determine which basis is being used. That is especially true of the tax and cash bases. Accordingly, the following paragraphs discuss each of the four bases in greater detail and offer guidance for determining the basis of accounting used in financial statement presentations and the appropriate report to be issued. Before turning to a detailed discussion of each of the bases, a review of the factors common to each basis is appropriate.

Application of an OCBOA

When OCBOA financial statements are presented, the basis of accounting must be applied to all material amounts in the financial statements. For example, a presentation using the cash basis for selected accounts and the company's tax basis for other accounts (assuming amounts differ under the two bases) is not appropriate.

Basic Financial Statements for an OCBOA

In an OCBOA presentation, the basic financial statements typically present financial position and results of operations as measured under the OCBOA, descriptions of accounting policies, and notes to the financial statements. An exception to that exists for entities using the pure cash basis of accounting, however. Under the pure cash method, a statement of assets, liabilities and equity would be superfluous because the cash balance would be the only item that would appear, and a statement of changes in equity would be unnecessary because the cash basis does not recognize equity. Consequently, entities using the pure cash basis of accounting present a single statement titled "Statement of Cash Receipts and Disbursements."

Statement of Cash Flows. Interpretation No. 14 of SAS No. 62, "Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity with an Other Comprehensive Basis of Accounting (OCBOA)," notes that a statement of cash flows is not required in cash, modified cash, or income tax basis financial statements. In practice, many entities present statements of cash flows in OCBOA presentations anyway. In such cases, the statement of cash flows should be treated and reported on as a basic financial statement—not as supplemental information.

Comprehensive Income. SFAS No. 130 *Reporting Comprehensive Income* (FASB ASC 220), requires comprehensive income and its components to be reported when an entity presents a full set of financial statements that report financial position, results of operations, and cash flows. If a statement of cash flows is not presented, best practices indicate reporting comprehensive income is not required. Comprehensive income includes net income and other changes in assets and liabilities that are not reported in income, but as a separate component of stockholders' equity.

Statement Titles

Because OCBOA financial statements do not purport to present financial position and results of operations in conformity with GAAP, SAS No. 62 at AU 623.07 indicates that they should not be titled or otherwise referred to as "balance sheet" or "income statement" without appropriate modification. SAS No. 62 suggests various titles for OCBOA financial statements, some of which are potentially confusing to users. For example, a suggested title for a cash basis balance sheet in SAS No. 62 is "Statement of Assets and Liabilities Arising from Cash Transactions." That title suggests that the only liabilities reflected on the statement would be those arising from borrowed cash. However, it is common to accrue the liability for federal income taxes on a cash basis statement, along with FICA and tax withholdings not deposited with the IRS. The suggested title for a cash basis statement of income in SAS

No. 62 is "Statement of Revenues Collected and Expenses Paid." However, it is common for cash basis statements to include depreciation expense on property and equipment, a "nonpaid expense." Because of those limitations, a standard title for OCBOA statements that correctly describes the content of the statement followed by a hyphen and a description of the basis of accounting is recommended. The following table illustrates suggested titles:

Exhibit 1-1

Sample Statement Titles

GAAP Titles	OCBOA Titles
Balance Sheet	Statement of Assets, Liabilities, and Stockholders' Equity (Partners' Capital, Proprietor's Capital)—Regulatory Basis[a] (Income Tax Basis, Cash Basis, Modified Cash Basis, etc.)
Statement of Income	Statement of Revenue and Expenses—Regulatory Basis (Income Tax Basis, Cash Basis, Modified Cash Basis, etc.)
Statement of Changes in Stockholders' Equity	Statement of Changes in Stockholders' Equity (Partners' Capital, Proprietor's Capital)—Regulatory Basis (Income Tax Basis, Cash Basis, Modified Cash Basis, etc.)
Statement of Income and Retained Earnings	Statement of Revenue, Expenses, and Retained Earnings (Partners' Capital, Proprietor's Capital)—Regulatory Basis (Income Tax Basis, Cash Basis, Modified Cash Basis, etc.)

Note:

[a] Some regulatory agencies recommend specific titles that should be used in lieu of these titles.

* * *

Note that the preceding discussion relates to the title of the statement only. Within the body of the financial statement, some auditors also believe alternative captions for net income and retained earnings should be used, such as "excess of revenue collected over expenses paid" and "accumulated excess of revenue collected over expenses paid," respectively. However, such captions may be confusing, and SAS No. 62 (AU 623) does not prohibit the use of captions such as "net income" and "retained earnings" in OCBOA financial statements.

SAS No. 62 (AU 623) states that if auditors believe the financial statements are not suitably titled, they should disclose their reservations in an explanatory paragraph and qualify their opinion.

Disclosures in OCBOA Statements

Auditors have encountered some difficulty in evaluating whether disclosures in OCBOA financial statements are adequate. As a general rule, disclosure guidelines for OCBOA financial statements are not as well defined as they are for GAAP financial statements.

SAS No. 62 at AU 623.09 offers general guidance regarding OCBOA disclosures. It states:

> The auditor should apply essentially the same criteria to financial statements prepared on an other comprehensive basis of accounting as he or she does to financial statements prepared in conformity with generally accepted accounting principles. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation as discussed in (AU) section 411, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles"*, paragraph 4.

The notes accompanying OCBOA financial statements should include a summary of significant accounting policies that discusses the basis of presentation and how it differs from generally accepted accounting principles. The effects of the differences between GAAP and the basis of presentation need not be disclosed. The primary point made in SAS No. 62 (AU 623) is that when financial statements contain items that are the same as, or similar to, those in GAAP financial statements, then similar informative disclosure is generally appropriate. Interpretation No. 14 of SAS No. 62 at AU 9623.90–.95 provides additional guidance on disclosures in OCBOA financial statements. The interpretation requires OCBOA financial statements with items requiring disclosure under GAAP to either follow the GAAP disclosure requirements for those items or provide information that communicates the substance of those GAAP requirements. Thus, the disclosures in OCBOA financial statements do not have to be identical to GAAP disclosures as long as they communicate the substance of the GAAP requirements. For example, if disclosing the terms of debt agreements communicates information about the minimum payments required over the next five years, disclosing a schedule of the future minimum payments related to debt agreements may not be necessary.

Best practices indicate that the following disclosures (which are not necessarily all-inclusive) are normally needed regardless of the basis of accounting used:

- Significant accounting policies.
- Income taxes (for example, uncertain tax positions, net operating loss carryovers, and expiration dates).
- Commitments, contingencies, and uncertainties (including going-concern matters).
- Terms of debt and lease agreements.
- Employee benefit plans.
- Changes in accounting principles or estimates.
- Related party transactions.
- Restrictions on assets and owners' equity.
- Subsequent events.

SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (FASB ASC 275), has caused debate about whether it should be applied for OCBOA financial statements. The applicability of GAAP disclosure requirements to OCBOA financial statements is a pervasive issue that is beyond the scope of this guidance. Consequently, this guidance does not provide a definitive answer. Absent any such guidance, auditors should look to SAS No. 62 (AU 623) and Interpretation No. 14, as discussed in the preceding paragraphs. Based on that guidance, it would appear that the disclosure requirements of SOP 94-6 (FASB ASC 275) should be considered for OCBOA financial statements. However, as noted previously, auditors must use judgment in determining which disclosures are necessary in OCBOA financial statements. As a practical matter, the nature of a company's business is already disclosed in many financial statements, as well as economic dependence (which in many cases will satisfy requirements for disclosure of concentrations). That leaves only disclosures related to estimates (use of estimates and certain significant estimates). Often, preparation of OCBOA financial statements may not require significant estimates. Consequently, SOP 94-6 (FASB ASC 275) may have little or no effect on many OCBOA financial statements. However, the need for its disclosures must be determined on a case-by-case basis, based on the facts and circumstances in each individual engagement.

Another disclosure problem is often posed by SFAS No. 5, *Accounting for Contingencies* (FASB ASC 450), which establishes two criteria for recording a loss contingency in GAAP financial statements. The loss must be (a) probable and (b) estimable. Do those criteria apply to OCBOA financial statements? Best practices indicate that GAAP *measurement* principles do not apply to OCBOA financial statements. For example, under the cash basis, the loss would not be recorded until realized. However, to achieve adequate disclosure, the loss contingency should, nonetheless, be disclosed.

In deciding which disclosures are required in OCBOA financial statements, auditors generally should be guided by the third standard of reporting, which states that informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report. Information that is necessary to keep the financial statements from being misleading should be disclosed.

Standard Report on OCBOA Statements

The standard report on OCBOA financial statements prescribed in SAS No. 62 (AU 623) is, in many respects, similar to the standard report on GAAP basis financial statements prescribed by SAS No. 58 (AU 508). Except for using different financial statement titles to describe the statements being reported on, the introductory paragraphs in both reports are identical. Also, the scope paragraphs in both reports contain the same language. However, SAS No. 62 prescribes certain requirements for a report on OCBOA financial statements that differ from the SAS No. 58 standard report. SAS No. 62 states that a standard report on OCBOA financial statements should include the following:

- A paragraph that states the basis of presentation and refers to the note that describes the basis, and states that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles

- A paragraph that expresses an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the basis of accounting described

Also, if the financial statements are prepared in conformity with the requirements of a government regulatory agency, AU 623 requires an additional paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity and the regulatory agencies to whose jurisdiction the entity is subject, and is not intended to be and should not be used by anyone other than those specified parties. If the financial statements and report are intended for use by parties other than those within the entity and the regulatory agencies to whose jurisdiction the entity is subject, the guidance in AU 544, *Lack of Conformity with Generally Accepted Accounting Principles*, should be followed.

Circumstances Requiring Explanatory Language

Auditors are often faced with circumstances that, while not precluding an unqualified opinion, require explanatory language to be added to the standard report. Generally, the explanatory language describing those circumstances in OCBOA reports is the same as the explanatory language found in reports on GAAP basis financial statements.

Auditors may wish to add explanatory language to their report to disclose a change in the basis of accounting from GAAP to OCBOA. In addition, an explanatory paragraph may be necessary if the OCBOA financial statements contain a departure from the basis of accounting.

Departures from an OCBOA

When financial statements are presented on an OCBOA and the auditors conclude that they are not presented fairly on the basis of accounting described, a qualified or adverse opinion should be expressed. A separate explanatory paragraph should disclose all of the substantive reasons for the qualification and their principal effects, if reasonably determinable. If the effects cannot be reasonably determined, the explanatory paragraph should so state. A qualified opinion paragraph would state that "except for" the effects of the departure, the financial statements present fairly the assets, liabilities, equity, revenues, and expenses "on the basis of accounting described." Note that the terms *financial position* and *results of operations* would not be used since that terminology relates only to GAAP basis statements.

REPORTING USING REGULATORY BASIS FINANCIAL STATEMENTS

Applicability

When reporting on financial statements that are prepared in conformity with the requirements or financial reporting provisions of a government regulatory agency, the appropriate form of report depends on the use of the reports. SAS No. 62 (AU 623.05) allows auditors to report on regulatory basis financial statements as OCBOA financial statements if they are used solely by parties within the entity and one or more regulatory agencies. Otherwise, the auditor's report should be modified ("except for" or adverse opinion) for any material GAAP departures relating to the regulatory basis. For example, if regulatory basis financial statements of a not-for-profit organization are distributed to potential donors, the auditor's report should be modified for the GAAP departures.

Report on Regulatory Basis Financial Statements Used Solely for Regulatory Filing

As previously noted, if regulatory basis financial statements are intended to be used solely by parties within the entity and one or more regulatory agencies, the auditor can report on them as OCBOA financial statements. The following form of report is appropriate for reporting on financial statements prepared on a basis of accounting used by the reporting entity to comply with the requirements or financial reporting provisions of a government regulatory agency to whose jurisdiction the company is subject. In this example, the auditors are reporting on the regulatory basis financial statements of a contractor for inclusion in a state prequalification report, which contractors are frequently required to submit as a condition for bidding on, or performing work on, government projects.

INDEPENDENT AUDITOR'S REPORT

To XYZ Contractors[a]

We have audited the accompanying statements of assets, liabilities, and surplus[b] of XYZ Contractors (a Texas corporation) as of December 31, 20X1, and the related statements of income and surplus[b] for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.[c]

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

As described in Note X, these financial statements for state prequalification filing were prepared in conformity with the accounting practices prescribed or permitted by the state in which they were filed,[d] which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and surplus of XYZ Contractors as of December 31, 20X1, and the results of its operations for the year then ended, on the basis of accounting described in Note X.[e]

This report is intended solely for the information and use of the board of directors and management of XYZ Contractors and (name of government agency) and is not intended to be and should not be used by anyone other than these specified parties.[f]

Notes:

[a] The report is addressed to the client. Special reports generally should not be addressed solely to third parties. In some circumstances, it may be appropriate to address the report to the client and third parties jointly. This report should be used only by those within the entity and one or more regulatory agencies. Therefore, the report should not be addressed to the stockholders, and it should not be distributed to them.

[b] The financial statements should be titled using terms that do not imply financial presentations in conformity with generally accepted accounting principles. The titles should reflect terms used within the body of the statements as prescribed by the agency whose basis of accounting is being used.

[c] The report includes the standard introductory and scope paragraphs that identify the financial statements audited and state that the audit was made in accordance with GAAS.

[d] The explanatory paragraph of the report states the basis of presentation, indicating that it is a comprehensive basis of accounting other than GAAP, and refers to the note to the financial statements that describes the basis. The note should describe how the basis of presentation used differs from generally accepted accounting principles. Disclosure of the monetary effects of differences between GAAP and the basis used is not required. However, there may be circumstances when such disclosure is necessary to keep the statements from being misleading.

[e] The opinion paragraph expresses the auditors' opinion about whether the financial statements are presented in conformity with the prescribed basis of accounting. If the auditors conclude that the financial statements are not presented fairly on the prescribed basis, they should disclose their reasons for that conclusion in an additional explanatory paragraph of their report preceding the opinion paragraph and should include appropriate modifying language and a reference to the explanatory paragraph in the opinion paragraph of their report.

[f] This form of reporting on financial statements prepared in conformity with a basis of accounting prescribed by a government regulatory agency may be used only if the financial statements are intended for use by those within the entity and one or more regulatory agencies. The report may still be used, however, when, by law or regulation, the audit report becomes a matter of public record.

Report on Regulatory Basis Financial Statements That Are Not Limited to Use in Regulatory Filings

SAS No. 1 (AU 544) and Interpretation 15 of AU 623, "Auditor Reports on Regulatory Accounting or Presentation When the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request," provide guidance on the form or reporting for financial statements prepared on a basis of accounting prescribed by a regulatory agency when the financial statements will not be limited to use in regulatory filings. In this situation, a restricted use paragraph would not be included. AU 544 states that when the regulatory basis contains departures from GAAP, the auditors' report should be the standard form of report prescribed by SAS No. 58 (AU 508), modified (i.e., an "except for" or adverse opinion) because of the prescribed GAAP departures. The report also may include an additional paragraph that expresses an opinion on whether the financial statements are in conformity with the prescribed basis of accounting. Similarly, Interpretation No. 15 confirms that this type of reporting is required when:

a. the financial statements and report are intended for use by parties other than those within the entity and one or more regulatory agencies to whose jurisdiction the entity is subject, or

b. the financial statements and report are distributed (either voluntarily or upon specific request) by the entity to parties other than the regulatory agencies to whose jurisdiction the entity is subject.

Although Interpretation 15 applies to all regulated entities, the Interpretation specifically mentions certain state and local governmental entities that prepare financial statements under the requirements of a governmental regulatory agency.

SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*, as amended, provides similar guidance on the form of report when auditors are requested to report on the financial statements of a stock life insurance company that are prepared in conformity with the basis of accounting used to comply with requirements of a regulatory agency and that are not limited to use in regulatory filings. The following report is based on that discussion.

INDEPENDENT AUDITOR'S REPORT

To XYZ Insurance Company

We have audited the accompanying statutory statement of admitted assets, liabilities, and surplus of XYZ Insurance Company (a Texas corporation) as of December 31, 20X1, and the related statutory statements of income and changes in surplus, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As described 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 Texas, 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 in the first paragraph do not present fairly, in conformity with accounting principles generally accepted in the United States of America,[a] the financial position of XYZ Insurance Company as of December 31, 20X1, or the results of its operations or its cash flows for the year then ended.

However, in our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended, on the basis of accounting described in Note X.[b, c]

Notes:

[a] The fourth paragraph of the report expresses an adverse opinion on the presentation of the financial statements in conformity with GAAP. When an adverse opinion is issued, SAS No. 58 at AU 508.59 requires auditors to disclose the principal effects of the subject matter on the company's financial position, results of operations, and cash flows in a separate paragraph of their report, if practicable.

[b] As allowed by AU 544.04, the last paragraph expresses an unqualified opinion on the presentation of the financial statements in accordance with the regulatory basis of accounting.

[c] The report does not include a restricted use paragraph.

Reporting When a State or Local Government Does Not Adopt GASB No. 45. A new type of regulatory basis of accounting arose in 2007 when the Texas legislature passed and the governor signed legislation that would provide all governmental entities in Texas with an alternative to following GASBS No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. According to Paragraph .19 of the 2007 AICPA governmental audit risk alert, that alternative basis of accounting is considered to be another comprehensive basis of accounting, which essentially follows GAAP except as it relates to OPEB. Supporters of the legislation argued that Texas governments are constitutionally prohibited from entering into long-term obligations such as OPEB, and that recording such a long-term obligation would misrepresent the government's financial condition. They do not support the notion that an OPEB liability exists based on a substantive plan or constructive obligation as put forth in GASBS Statement No. 45. That position has been questioned by many outside of Texas.

For those governmental entities that choose to not implement GASBS No. 45 but instead follow the statutory accounting method, auditors will need to issue a modified opinion due to the GAAP departure if the reports will be distributed to others outside of the entity or the regulatory agency.

IRS Form 990

Some states allow charitable organizations to use IRS Form 990 (Return of Organizations Exempt from Income Tax) as a uniform annual report for reporting to both state and federal governments. Some states require that the forms filed be accompanied by an auditor's report on the financial statements included in the form. SAS No. 1 (AU 544) and SAS No. 62 (AU 623) and an AICPA auditing interpretation at AU 9623.47 give guidance on the appropriate audit report for Form 990. As discussed below, the form of report is determined by whether the financial statements presented on the Form 990 are in conformity with GAAP and by the use that will be made of the report.

Naturally, if the financial statements included in Form 990 are in conformity with GAAP, auditors should issue a standard report with an unqualified opinion. However, financial statements included in Form 990 often contain certain departures from GAAP for such organizations. In those situations, the appropriate form of report is determined by the intended use of the report. In most states, the report is used solely to satisfy regulatory requirements, and the regulatory authorities make the financial statements and audit report a matter of public record. In some situations, however, the Form 990 will be used for purposes other than regulatory filings.

When financial statements presented on Form 990 contain GAAP departures required by a state agency, the report form for a regulatory basis of accounting described in SAS No. 62 at AU 623.08 and discussed above is appropriate only if the financial statements will be used solely by parties within the entity and one or more regulatory agencies, including those situations in which, by law or regulation, the report may be made a matter of public record.

If the Form 990 will be used for purposes other than regulatory filings (for example, copies of the Form 990 are distributed to contributors or others), the report form in SAS No. 62 at AU 623.08, is not appropriate. In those cases, auditors should express a qualified or adverse opinion on the financial statements. The auditing interpretation (AU 9623.47) does not discuss whether auditors may add a paragraph expressing an opinion on conformity with the accounting principles prescribed by the regulatory basis.

Can Form 990 Financial Statements Be Reported on as Tax Basis Financial Statements? Interpretation 14 of SAS No. 62 provides examples of nonprofit entities using the accounting principles followed in filing Form 990, thus acknowledging that such entities may issue tax basis financial statements based on financial information included in Form 990.

REPORTING USING INCOME TAX BASIS FINANCIAL STATEMENTS

Determining the Appropriate Basis

SAS No. 62 at AU 623.04 states that the basis of accounting a company uses or expects to use to file its tax return is an OCBOA. However, the bases of accounting allowed by tax law range from full accrual to the cash basis. Also, tax laws allow the use of accounting principles that are neither the accrual nor cash basis. Accordingly, it is sometimes difficult to determine whether such financial statements should be described and reported on as GAAP, cash, or tax basis. The general guidelines discussed in the following paragraphs may be used to determine how to describe and report on tax basis financial statements.

If the basis of accounting used to file the tax return is accrual, the additional costs of preparing GAAP financial statements may be minimal. Accordingly, it is normally preferable to describe and report on such financial statements as GAAP. However, that general advice is not appropriate if an agreement, e.g., a partnership agreement, specifically calls for the use of the tax basis because (a) it would be confusing to the users of the financial statements to refer to the statements as GAAP when they expect the tax basis (even if the two are the same) and (b) in future years tax laws may require tax accounting treatment that would be materially different from GAAP, causing a very confusing auditor's report in the year when use of the tax basis causes material GAAP departures.

Practice varies when the tax return is filed using the cash basis. First, the client must decide if the cost to convert to GAAP financial statements exceeds the benefits. If the client decides to present the financial statements on the same basis used in filing the tax return, some auditors identify and report on the statements as cash basis or modified cash basis, while other auditors identify and report on the statements as tax basis. For the reasons mentioned in the preceding paragraph, if an agreement calls for the tax basis, best practice indicates that auditors report on that basis. Also, the general practice for entities organized for profit is to refer to the tax basis.

When the basis of accounting used to file the tax return contains an unusual tax treatment that is not appropriate for either the GAAP or cash basis financial statements, and the cost of converting to GAAP statements exceeds the benefits, the financial statements should be identified and reported on as tax basis. Examples of such tax elections are: (This list is not all-inclusive.)

- Depreciation computed in accordance with the modified accelerated cost recovery system resulting in material differences from depreciation computed on estimated useful lives

- Capitalizing certain inventory-related costs that are not capitalized under GAAP.

- Deduction of statutory depletion.

- Deduction of intangible development costs on producing oil and gas wells.

- Use of property valuations allowed for tax purposes that differ materially from historical costs (stepped-up basis).

- Accounting for investments in other entities that would be required to be consolidated or carried on the equity basis in GAAP financial statements at cost.

- Accounting for leases that meet the requirements of capital leases under SFAS No. 13 (FASB ASC 840) as operating leases for tax purposes.

Uncertainties Regarding Tax Positions

Depending on the facts and circumstances, there may be varying views on the appropriate income tax treatment of a transaction. Therefore, there may be uncertainty about whether a tax position would be sustained by the taxing authority in the event it examined the position. FASB Interpretation No. (FIN) 48, "Accounting for Uncertainty in Income Taxes (FASB ASC 740)," clarifies that SFAS No. 5, *Accounting for Contingencies* (FASB ASC 450), does not apply to accounting for uncertainty in income taxes. Instead, uncertain tax positions should be accounted for in accordance with the provisions of FIN 48 (FASB ASC 740), which (a) prescribes a recognition threshold (more likely than not) for recording a tax position in financial statements, (b) for those tax positions for which there is greater than a 50% chance of being sustained, prescribes how the tax positions should be measured, (c) requires measuring the amount to recognize in the financial statements by establishing various probability scenarios, and (d) requires recognizing the largest benefit that has greater than a 50% chance of being sustained. The requirements apply to all entities that prepare GAAP financial statements. FSP FIN 48-3, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, defers the effective date of FIN 48 (FASB ASC 740) for nonpublic companies other than those that (a) are a consolidated entity of a public entity that applies U.S. GAAP or (b) have applied FIN 48 (FASB ASC 740) in a full set of U.S. GAAP annual financial statements to annual financial statements for fiscal years beginning after December 15, 2008 (FASB ASC 740-10-15-2A).

The recognition and measurement principles of FIN 48 (FASB ASC 740) do not apply to OCBOA financial statements. However, Interpretation 14 of SAS No. 62 at AU 9623.90–.95 states that if OCBOA financial statements contain amounts for which GAAP would require disclosure, the statements should either provide the relevant disclosure that would be required for those amounts in a GAAP presentation or provide information that communicates the substance of that disclosure. Best practices indicate that the following disclosures required by FIN 48 (FASB ASC 740-10-50) would be required in OCBOA financial statements:

- Amount of interest and penalties related to income taxes.

- Tax years that remain subject to examination by major tax jurisdictions.

Adjustments to income taxes paid in prior years as a result of IRS agent examinations usually fall into two categories: (a) those resulting from errors, such as mathematical mistakes and disregarding or misusing facts that existed at the date of the financial statements (for example, using an incorrect income tax rate); or (b) those resulting from negotiated settlements of grey areas of tax law. Depending on the facts and circumstances, adjustments to income taxes paid in prior years should be accounted for as either error corrections or changes in accounting estimates as provided in SFAS No. 154 (FASB ASC 250). Penalty and interest should be reported in accordance with FIN 48 (FASB ASC 740-10-45-25 and 50-19).

Consolidation of Variable Interest Entities

An AICPA Technical Practice Aid at TIS 1500.06 indicates that the consolidation provisions of FASB Interpretation (FIN) No. 46(R), *Consolidation of Variable Interest Entities* (FASB ASC 810), does not apply to financial statements prepared on the income tax basis of accounting because consolidation in income tax basis financial statements is based on the provisions of the Internal Revenue Code. However, SAS No. 62 at AU 623.09 states that if OCBOA financial statements contain elements, accounts, or items for which GAAP would require disclosure, the OCBOA statements should either provide the relevant disclosure that would be required for those items in a GAAP presentation or provide information that communicates the substance of that disclosure. Thus, TIS 1500.06 states that the tax basis financial statements of the primary beneficiary of a VIE should consider disclosing the same matters that the parent of a subsidiary would disclose in its tax basis financial statements when the GAAP threshold for consolidation has been met but consolidated financial statements are not presented because the threshold for consolidation under the Internal Revenue Code has not been met. TIS 1500.06 states as follows:

> A variable interest entity that is not consolidated under the income tax basis of accounting is analogous to a 60%-owned subsidiary that would be consolidated under GAAP but is not consolidated under the income tax basis of accounting because the threshold for consolidation under the Internal Revenue Code is 80% ownership. The primary beneficiary of the VIE should perform the same analysis in determining which disclosures are appropriate as would the parent of the 60%-owned subsidiary. Examples of matters that might require disclosure are related-party transactions, guarantees, and commitments.

Standard Report on Tax Basis Financial Statements

The following is an example of a report that is appropriate for reporting on financial statements prepared on the basis of accounting that the company uses or expects to use to file its income tax return for the period covered by the financial statements.

INDEPENDENT AUDITOR'S REPORT

To ABC Partnership[a]

We have audited the accompanying statement of assets, liabilities, and capital—income tax basis[b] of ABC Partnership as of December 31, 20X1, and the related statements of revenue and expenses—income tax basis and changes in partners' capital—income tax basis[b] for the year then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audit.[c]

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and partners' capital of ABC Partnership as of December 31, 20X1, and its revenue and expenses and changes in partners' capital for the year then ended, on the basis of accounting described in Note X.[f]

Notes:

[a] The report is addressed to the client. Tax basis financial statements usually are requested by the client; accordingly, only in rare circumstances will an auditor's report be addressed to a third party. The report should not be addressed to stockholders unless it is intended for their use.

[b] The financial statements should be titled using terms that do not imply financial presentation in conformity with GAAP. Titles should reflect terms used within the body of the financial statements.

[c] The report includes the standard introductory and scope paragraphs that identify the financial statements audited and state that the audit was made in accordance with GAAS.

[d] The explanatory paragraph of the report states the basis of presentation and refers to the note to the financial statements that describes the basis. The note should describe how the basis of presentation differs from GAAP. Disclosure of the monetary effects of the differences between GAAP and the tax basis is not required. However, the authors believe that there may be circumstances when such disclosure is necessary to prevent the statements from being misleading, for example, when the absence of accruals conceals working capital deficiencies.

[e] The explanatory paragraph states that the income tax basis is an OCBOA.

[f] The last paragraph expresses the auditors' opinion about whether the financial statements are presented in conformity with the income tax basis of accounting. If the auditors conclude that the financial statements are not fairly presented on that basis, they should disclose their reasons for that conclusion in an explanatory paragraph of the report preceding the opinion paragraph and should include appropriate modifying language and refer to the explanatory paragraph in the opinion paragraph of their report.

Reporting on Consistency When Tax Basis Financial Statements Are Presented

When a company changes an accounting principle, the auditors should refer to the change in an explanatory paragraph of their report. According to SAS No. 62 (AU 623.31, footnote 36) a change in tax law is not considered to be a change in accounting principle for which auditors need to add an explanatory paragraph for consistency, although disclosure may be necessary. On the other hand, if a company presents tax basis financial statements and changes its treatment of an item for tax purposes, the auditors would add a consistency paragraph to their report for a change in accounting principle. (If a company presents GAAP basis financial statements, a change in the treatment of an item for income tax purposes is not a change in accounting principle requiring a consistency paragraph.)

Standards of Generally Accepted Tax Accounting Principles

In 1984, the National Society of Public Accountants (NSPA) issued a document entitled *Standards of Generally Accepted Tax Accounting Principles*. The document asserted its intention to "formalize" generally accepted practices for the preparation of tax basis financial statements, and it includes "sample transmittal letters" that express different levels of assurance about the tax basis financial statements. The AICPA subsequently cautioned accountants not to look to the document for guidance. The AICPA cautionary statement characterized the NSPA document as confusing, incomplete, and incorrect, and it stated that the deficiencies could expose users of the document to legal hazards.

REPORTING USING CASH BASIS FINANCIAL STATEMENTS

Modifications Having Substantial Support

The pure cash basis of accounting is rarely used in practice. Instead, a hybrid or modified cash basis usually is used. SAS No. 62 at AU 623.04 allows the use of any modifications of the cash basis having substantial support. An AICPA Technical Practice Aid at TIS 1500.05 defines modifications having substantial support as those in which the method (a) is equivalent to the accrual basis of accounting for a particular item and (b) is not illogical (such as recording revenue on the accrual basis and recording purchases and other costs on the cash basis).

If clients use modifications of the cash method that do not have substantial support or are illogical, auditors should describe them in an explanatory paragraph of their report and appropriately modify their opinion.

In some cases, the omission of accruals and other departures from GAAP does not have a material effect on financial position and results of operations. In those circumstances, auditors may use the standard report. However, best practices indicate that the OCBOA report always should be used for cash basis statements. Even though accruals may be immaterial one year, they may become material in the future, and auditors would find it necessary to change their report.

Standard Report on Cash Basis Financial Statements

The following is an example of a report that is appropriate for cash basis financial statements.

INDEPENDENT AUDITOR'S REPORT

To ABC Clinic[a]

We have audited the accompanying statement of assets, liabilities, and stockholders' equity—cash basis[b] of ABC Clinic (a professional corporation) as of December 31, 20X1, and the related statements of revenue and expenses—cash basis and changes in stockholders' equity—cash basis[b] for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.[c]

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

As described in Note X, these financial statements were prepared on the cash basis of accounting,[d] which is a comprehensive basis of accounting other than generally accepted accounting principles.[e]

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and stockholders' equity of ABC Clinic as of December 31, 20X1, and its revenue and expenses and changes in stockholders' equity for the year then ended, on the basis of accounting described in Note X.[f]

Notes:

[a] The report is addressed to the client. Special reports generally should not be addressed solely to third parties. In some circumstances, it may be appropriate to address the report to the client and third parties jointly. The report should not be addressed to the stockholders unless it is intended for their use.

[b] The titles of cash basis financial statements should avoid terms such as balance sheet and statement of income, because such terms normally apply to GAAP presentations.

[c] The report includes the standard introductory and scope paragraphs that identify the financial statements audited and include a statement that the audit was made in accordance with GAAS.

[d] The explanatory paragraph of the report states the basis of presentation and refers to a note to the financial statements that describes the basis. The note should describe how the basis differs from GAAP. The monetary effects of such differences need not be disclosed. However, the authors believe that in some circumstances, such disclosure may be necessary to keep the statements from being misleading, e.g., when the omission of accruals conceals working capital deficiencies.

[e] The explanatory paragraph states that the cash basis of accounting is an OCBOA.

[f] The last paragraph of the report expresses the auditors' opinion about whether the financial statements are presented in conformity with the cash basis of accounting. If the auditors conclude that the financial statements are not fairly presented on that basis, they should state their reasons for that conclusion in a separate explanatory paragraph of their report preceding the opinion paragraph and should appropriately modify their opinion and refer to the explanatory paragraph.

Statement of Cash Receipts and Disbursements Only

Rather than preparing a statement of assets, liabilities, and stockholders' equity—cash basis and the related statements of revenue and expenses—cash basis and changes in stockholders' equity—cash basis, some companies, particularly smaller ones, may elect to present only a statement of cash receipts and disbursements. An AICPA Technical Practice Aid (TIS 9110.07) states that a statement of cash receipts and disbursements is a pure cash basis financial statement and represents a comprehensive basis of accounting other than GAAP.

The following report is based on an example included in the Technical Practice Aid at TIS 9110.07, and is appropriate when reporting on a statement of cash receipts and disbursements.

INDEPENDENT AUDITOR'S REPORT

To ABC Clinic

We have audited the accompanying statement of cash receipts and disbursements of ABC Clinic (a professional corporation) for the year ended December 31, 20X1.[a] This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

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

As described in Note X, this financial statement has been prepared on the cash receipts and disbursements basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statement referred to in the first paragraph presents fairly, in all material respects, the cash receipts and disbursements of ABC Clinic[b] for the year ended December 31, 20X1, on the basis of accounting described in Note X.

Notes:

[a] The only financial statement identified in the introductory and scope paragraphs is the statement of cash receipts and disbursements.

[b] The auditors express an opinion only on the cash receipts and disbursements of the company for the year.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Several of the clients of IMA CPA issue non-GAAP financial statements. Which client below issues OCBOA financial statements?

   a. Oversea Inc. prepares financial statements in conformity with international financial reporting standards (IFRS).

   b. Foreign Inc. prepares financial statements in conformity with accounting principles generally accepted in another country.

   c. Candy Inc. prepares financial statements using a definite set of criteria having substantial support that is applied to all material items.

2. A single statement is presented by entities using which of the following bases of accounting?

   a. Modified cash basis of accounting.

   b. Pure cash basis of accounting.

3. According to the text, best practices indicate that all of the following disclosures would be needed when the tax basis of accounting is used **except**:

   a. Terms of lease agreements.

   b. Contingencies.

   c. All accounting policies.

   d. Uncertain tax positions.

4. SFAS No. 5, *Accounting for Contingencies* (FASB ASC 450), establishes two criteria, probable and estimable, for recording a loss contingency in:

   a. GAAP financial statements.

   b. OCBOA financial statements.

5. Which of the following provides guidance on the form of report to use when auditors are requested to report on the financial statements of a stock life insurance company prepared in conformity with the basis of accounting used to comply with a regulatory agency's requirements and that are not limited to use in regulatory filings?

   a. SOP 95-5.

   b. SAS No. 62 (AU 623.05).

   c. SAS No. 1 (AU 544).

   d. Interpretation 15 of AU 623.

6. Of the following statements regarding IRS Form 990, which one is accurate?

   a. All states allow charitable organizations to use Form 990 as a uniform annual report for reporting to both state and federal governments.

b. All states require that Form 990 be accompanied by an auditor's report on the financial statements that have been included in the form.

c. The form of the report is solely determined based on whether the financial statements presented on the Form 990 are in conformity with GAAP.

d. In most states, the auditor's report accompanying Form 990 is used exclusively to comply with regulatory requirements.

7. When an entity is organized for-profit, and files its tax return using the cash basis, its financial statements should generally be identified and reported on as:

   a. Cash basis.

   b. Modified cash basis.

   c. Tax basis.

   d. Accrual basis.

8. Best practices indicate that the standard report should always be used for cash basis statements.

   a. True.

   b. False.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Several of the clients of IMA CPA issue non-GAAP financial statements. Which client below issues OCBOA financial statements? **(Page 229)**

   a. Oversea Inc. prepares financial statements in conformity with international financial reporting standards (IFRS). [This answer is incorrect. According to SAS No. 62 (AU 623) OCBOA financial statements do not include financial statements prepared using IFRS as issued by the International Accounting Standards Board.]

   b. Foreign Inc. prepares financial statements in conformity with accounting principles generally accepted in another country. [This answer is incorrect. Financial statements using accounting principles from another country are not considered OCBOA financial statements to be reported on under SAS No. 62 (AU 623). Instead the reporting standards in SAS No. 51 (AU 534) apply.]

   c. Candy Inc. prepares financial statements using a definite set of criteria having substantial support that is applied to all material items. [This answer is correct. This is one of four criteria representing the authoritative definition of OCBOA. Price-level basis of accounting is an example of this type of basis.]

2. A single statement is presented by entities using which of the following bases of accounting? **(Page 230)**

   a. Modified cash basis of accounting. [This answer is incorrect. Typically, under OCBOA presentations, the basic financial statements present financial position and results of operations as measured under OCBOA, descriptions of accounting policies, and notes to the financial statements. An exception exists, but it is not the modified cash basis of accounting.]

   b. Pure cash basis of accounting. [This answer is correct. Entities using the pure cash basis of accounting present a single statement titled "Statement of Cash Receipts and Disbursements" due to the fact that a statement of assets, liabilities and equity would be excessive. This is due to the fact that the cash balance would be the only item that would appear, and a statement of changes in equity would be unnecessary, since the cash basis does not recognize equity.]

3. According to the text, best practices indicate that all of the following disclosures would be needed when the tax basis of accounting is used **except**: **(Page 232)**

   a. Terms of lease agreements. [This answer is incorrect. The primary point made in SAS No. 62 (AU 623) is that when financial statements contain items that are the same as, or similar to those in GAAP financial statements, then similar informative disclosure is generally appropriate. Disclosures normally needed regardless of the basis of accounting used include terms of debt and lease agreements.]

   b. Contingencies. [This answer is incorrect. Disclosures are normally needed for contingencies, commitments, and uncertainties when the tax basis or any other basis of accounting is used because SAS No. 62 says disclosure is generally appropriate when items in OCBOA statements are similar to items in GAAP financial statements.]

   c. All accounting policies. [This answer is correct. Disclosures of *significant* accounting policies, not all accounting policies, are normally needed regardless of the basis of accounting used.]

   d. Uncertain tax positions. [This answer is incorrect. Based on authoritative guidance in SAS No. 62 when the tax basis (or any other basis) of accounting is used, disclosures are normally needed for income taxes such as uncertain tax positions, net operating loss carryovers, and expiration dates.]

4. SFAS No. 5, *Accounting for Contingencies* (FASB ASC 450), establishes two criteria, probable and estimable, for recording a loss contingency in: **(Page 232)**

a. **GAAP financial statements. [This answer is correct. SFAS No. 5 establishes two criteria for recording a loss contingency pertaining specifically to GAAP financial statements. The loss must be probable and estimable. These measurement principles do not apply to OCBOA financial statements because, for instance, a loss would not be recorded in cash basis statements until realized.]**

b. OCBOA financial statements. [This answer is incorrect. Best practices indicate that GAAP *measurement* principles do not apply to OCBOA financial statements. Under the cash basis, for example, the loss would not be recorded until realized.]

5. Which of the following provides guidance on the form of report to use when auditors are requested to report on the financial statements of a stock life insurance company prepared in conformity with the basis of accounting used to comply with a regulatory agency's requirements and that are not limited to use in regulatory filings? **(Page 235)**

a. **SOP 95-5. [This answer is correct. SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*, as amended, provides this guidance as allowed by AU 544.04. The last paragraph of the report can express an unqualified opinion on the presentation of the financial statements in accordance with the regulatory basis of accounting.]**

b. SAS No. 62 (AU 623.05). [This answer is incorrect. SAS No. 62 (AU 623.05) allows auditors to report on regulatory basis financial statements as OCBOA financial statements if they are used solely by parties within the entity and one or more regulatory agencies.]

c. SAS No. 1 (AU 544). [This answer is incorrect. SAS No. 1 (AU 544) provides guidance on the form or reporting for financial statements prepared on a basis of accounting prescribed by a regulatory agency when the financial statements will not be limited to use in regulatory filings.]

d. Interpretation 15 of AU 623. [This answer is incorrect. Interpretation 15 of AU 623, like SAS No. 1 (AU 544), provides guidance on the form or reporting for financial statements prepared on a basis of accounting prescribed by a regulatory agency when the financial statements will not be limited to use in regulatory filings. Even though Interpretation 15 applies to all regulated entities, the Interpretation specifically mentions certain state and local governmental entities that prepare financial statements under the requirements of a governmental regulatory agency.]

6. Of the following statements regarding IRS Form 990, which one is accurate? **(Page 237)**

a. All states allow charitable organizations to use Form 990 as a uniform annual report for reporting to both state and federal governments. [This answer is incorrect. Because it is up to each state to determine annual reporting requirements, *some* states, but not all, allow charitable organizations to use Form 990 as a uniform annual report for reporting to both state and federal governments.]

b. All states require that Form 990 be accompanied by an auditor's report on the financial statements that have been included in the form. [This answer is incorrect. Not all states require Form 990 to be accompanied by an auditor's report on the financial statements that have been included in the form. Each state sets their own reporting requirements.]

c. The form of the report is solely determined based on whether the financial statements presented on the Form 990 are in conformity with GAAP. [This answer is incorrect. The form of the report is determined by whether the financial statements presented on the Form 990 are in conformity with GAAP as well as for what purpose the report will be used.]

d. **In most states, the auditor's report accompanying Form 990 is used exclusively to comply with regulatory requirements. [This answer is correct. Due to regulatory authorities, the auditor's report is used solely to satisfy regulatory requirements in most states, and the financial statements and audit report are made a matter of public record.]**

7. When an entity is organized for-profit, and files its tax return using the cash basis, its financial statements should generally be identified and reported on as: **(Page 237)**

   a. Cash basis. [This answer is incorrect. If the client decides to present the financial statements on the same basis used in filing the tax return, some auditors identify and report on the statements as cash basis, however this generally is not the case when an entity is organized for-profit.]

   b. Modified cash basis. [This answer is incorrect. Some auditors identify and report on the statements as modified cash basis in cases where the client decides to present the financial statements on the same basis of accounting used in filing the tax return. This practice generally does not apply when an entity is organized for-profit.]

   c. Tax basis. [This answer is correct. The general practice for entities organized for-profit is to identify and report on such financial statements as tax basis.]

   d. Accrual basis. [This answer is incorrect. If the basis of accounting used to file the tax return is accrual, it is generally preferable to describe and report on such financial statements as GAAP.]

8. Best practices indicate that the standard report should always be used for cash basis statements. **(Page 240)**

   a. True. [This answer is incorrect. Auditors may use the standard report in cases where the omission of accruals and other departures from GAAP does not have a material effect on financial position and results of operations, but generally not for cash basis statements because accruals may become material in a following year.]

   b. False. [This answer is correct. Best practices indicate that the OCBOA report always should be used for cash basis statements because immaterial accruals in one year may become material in the future, and auditors will need to change their report.]

OTHER DEFINITE SETS OF CRITERIA THAT HAVE SUBSTANTIAL SUPPORT

One type of OCBOA under SAS No. 62 at AU 623.04-d is ". . . a definite set of criteria having substantial support that is applied to all material items appearing in financial statements . . ." It was included as an OCBOA primarily to facilitate reporting on price-level-adjusted financial statements. (The price-level basis of accounting is described in SOP 93-3, *Rescission of Accounting Principles Board Statements* (FASB ASC 255-10-45-2 through 45-4.) The price-level basis of accounting is the only other OCBOA explicitly mentioned in SAS No. 62. It is interesting to note that SAS No. 62 does not illustrate an auditor's report in accordance with AU 623.04-d.

Current-value Accounting

Many auditors have questions about how to report on presentations of current-value financial information. For example, is the current-value basis of accounting an OCBOA? Should auditors report only when current-value statements supplement historical cost financial statements, or can they also report on "stand alone" current-value presentations?

Many auditors have questioned whether the current-value basis of accounting meets the substantial support criteria requirement. Some auditors maintain that the current-value basis of accounting is an OCBOA because it constitutes a definite set of criteria having substantial support that is applied to all material items. Others believe that the current-value basis is not a definite set of criteria because of the difference between methods used in applying *current-value* accounting. For example, the term *current-value* is used to refer to any of the following methods of determining value:

a. Current cost or current replacement cost (input price)

b. Current market value (exit price)

c. Discounted cash flow (present value)

Some auditors believe that because of the lack of definitive guidance, they should not report on stand-alone current-value presentations as an OCBOA. Others believe that if the current-value financial statements are presented as a stand-alone presentation, it is appropriate to report on the current-value financial statements following the guidance on OCBOA reporting covered earlier in this lesson.

If a company presents current-value financial statements to supplement historical cost financial statements, generally auditors should follow the guidance in an auditing Interpretation of SAS No. 62 at AU 9623.55–.59 titled "Reporting on Current-Value Financial Statements that Supplement Historical-Cost Financial Statements in a General-Use Presentation of Real Estate Entities." The Interpretation states that auditors may report on such supplemental presentations following the guidance from SAS No. 62 at AU 623.29 on special-purpose financial statements not presented in conformity with GAAP or an OCBOA if (a) the measurement and disclosure criteria used to prepare the current-value financial statements are reasonable, and (b) competent persons ordinarily would obtain materially similar results using those criteria. Although the interpretation only discusses reports on supplemental current-value statements presented by real estate entities, its guidance generally can also be applied when other types of entities present such presentations. Best practices indicate that it is generally preferable to present current-value information together with historical cost financial information, since the historical cost information provides a point of reference that is important to the evaluation of the current-value financial information.

Individual items in current-value presentations usually are valued by the current-value measurement base considered appropriate for that item. For example, property and equipment often are presented on a current cost or current replacement cost basis, inventories at market value, and long-term obligations at present value. Thus, current-value presentations usually are based on a combination of valuation methods. In the absence of authoritative guidance on applying estimated current-value accounting to business entities, perhaps the best accounting guidance is FASB ASC 274 (formerly SOP 82-1, *Accounting and Financial Reporting for Personal Financial Statements*.)

Liquidation Accounting

Best practices indicate that the liquidation basis of accounting is an OCBOA when it is used by a company that is not in liquidation or for which liquidation does not appear imminent. A liquidation basis of accounting is considered GAAP for a company in liquidation or for which liquidation appears imminent.

The differences between the liquidation basis of accounting and the estimated current-value basis of accounting can be subtle. The liquidation basis of accounting presents assets at amounts *expected to be realized in liquidation* and liabilities at amounts *expected to be paid to creditors*. Under the estimated current-value basis of accounting, assets are presented at the *amounts at which they could be exchanged between well-informed and willing buyers and sellers* (that is, neither *compelled* to buy or sell) *at the date of the financial statements* and liabilities are presented at the *discounted amount of cash to be paid*. Liquidation values are sometimes used as estimates of current value.

Use of a liquidation basis of accounting for a going concern does not necessarily result in pro forma financial statements. Pro forma financial statements generally reflect the effect of one or a limited number of hypothetical or future transactions on a company's financial statements, whereas a liquidation basis of accounting is applied to all the items in the statements.

SPECIAL-PURPOSE FINANCIAL STATEMENTS PREPARED ON A BASIS PRESCRIBED IN AN AGREEMENT THAT RESULTS IN A PRESENTATION NOT IN CONFORMITY WITH GAAP AND OCBOA

Authoritative Literature

Sometimes auditors are asked to report on financial statements prepared on a basis of accounting prescribed in an agreement that results in a presentation that is not in conformity with generally accepted accounting principles or an other comprehensive basis of accounting. For example, a loan agreement or acquisition agreement may require the financial statements to be prepared in conformity with GAAP except for certain assets (e.g., receivables and inventories). Some auditors mistakenly believe that the attestation standards discussed later in this lesson apply in those situations. In fact, auditing standards rather than the attestation standards should be followed. SAS No. 62 (AU 623) outlines the reporting approach that is appropriate. That approach is also used to report on financial statements of a partnership that uses a special accounting treatment specified in a partnership agreement.

SAS No. 62 (AU 623) requires that the report contain an explanatory paragraph that:

- explains what the presentation is intended to present and refers to the note to the special-purpose financial statements that describes the basis of presentation, and
- states that the presentation is not intended to be a presentation in conformity with GAAP.

The report also should include a paragraph that describes and indicates the source of any significant interpretations made by the company's management relating to the provisions of a relevant agreement.

SAS No. 62 at AU 623.29 also requires reports on special-purpose financial statements that are neither GAAP nor OCBOA to contain an additional paragraph at the end of the report. The additional paragraph should state that the report is intended solely for the information and use of those within the entity, the parties to the contract, the regulatory agency with which the entity is filing the report, or parties with whom the entity is negotiating directly (that is, individuals who are able to ask questions of management and negotiate the terms or structure of a transaction with management), and is not intended to be and should not be used by anyone other than those specified parties.

REPORTING ON A SPECIAL-PURPOSE FINANCIAL PRESENTATION THAT DOES NOT QUALIFY AS A COMPLETE PRESENTATION BUT IS OTHERWISE IN CONFORMITY WITH GAAP OR OCBOA

Auditors may be requested to report on a special-purpose financial presentation prepared on a basis of accounting prescribed in a contractual agreement or regulatory provision that does not constitute a complete presentation of historical financial position or results of operations, but is otherwise in conformity with generally accepted accounting principles or an other comprehensive basis of accounting. For example, a regulatory agency might require a schedule of gross income and certain expenses, with expenses defined to exclude such items as interest, depreciation, and taxes. A lease agreement might have a similar requirement. Also, a buy-sell agreement may specify a schedule of certain assets and liabilities which, although measured in conformity with generally accepted accounting principles, do not constitute substantially all of the company's assets and liabilities. Reports on such presentations are covered by SAS No. 62 at AU 623.23–.26. SAS No. 62 requires the following:

- The presentation should be regarded as a financial statement (even though, as indicated earlier, certain items might be excluded).
- The presentation should differ from a complete financial statement only to the extent necessary to meet the special purpose for which the presentation was prepared. In all other respects, including note disclosures, GAAP should be followed.
- For expressing an opinion, materiality should be measured in relation to the presentation taken as a whole.

It may be difficult to distinguish a presentation of the type described above from (a) a presentation of specified elements, accounts, or items of a financial statement, as covered by SAS No. 62 at AU 623.15–.18 or (b) a financial statement prepared in conformity with accounting practices specified in an agreement, as covered by SAS No. 62 at AU 623.27–.30. A presentation of specified elements, accounts, or items of a financial statement refers to "accounting information that is part of, but *significantly less* than, a financial statement" (AU 623.24— emphasis added), e.g., one account, or several accounts or items that together do not represent a financial measure. The presentation in item (b) is a complete financial statement prepared on a basis that is not in conformity with either GAAP or OCBOA (e.g., inventory valued on a basis other than cost, as specified in an acquisition agreement). In contrast, the special-purpose presentation discussed in this lesson is a GAAP or OCBOA presentation prescribed in a contractual agreement or regulatory provision that is less than a complete financial statement (but more than just one or several specified accounts, items, or elements).

SAS No. 62 at AU 623.25 states that reports on special-purpose financial presentations should include:

- A paragraph that explains what the presentation is intended to present and refers to the note to the special-purpose financial statements that describes the basis of presentation. Also, if the basis of presentation is in conformity with GAAP, that paragraph should include a statement that the presentation is not intended to be a complete presentation of the company's assets, liabilities, revenues, and expenses. On the other hand, if the basis of presentation is in conformity with OCBOA, that paragraph should state that the basis is a comprehensive basis of accounting other than generally accepted accounting principles and that it is not intended to be a complete presentation of the company's assets, liabilities, revenues, and expenses on the basis described.
- A paragraph that expresses an opinion related to the fair presentation, in all material respects, of the information (e.g., net assets sold or income before depreciation, interest, and taxes) the presentation is intended to present in conformity with GAAP or with OCBOA. If the basis of presentation is in conformity with GAAP, that paragraph should include an identification of the U.S. as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America).
- An additional paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity, the parties to the contract, the regulatory agency with which the entity is filing the report, or parties with whom the entity is negotiating directly, and is not intended to be and should not be used by anyone other than those specified parties. No restrictive paragraph is required if the presentation is to be included in a document that is distributed to the general public, such as a prospectus.

Thus, the language in the report depends upon whether the incomplete presentation is otherwise in conformity with GAAP or with OCBOA. Presented below is an example of a report on a special-purpose presentation prescribed in a contract that results in an incomplete presentation but one that is otherwise in conformity with GAAP.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited the accompanying statement of net assets sold of ABC Company as of June 8, 20X1. This statement of net assets sold is the responsibility of ABC Company's management.[a] Our responsibility is to express an opinion on the statement of net assets sold based on our audit.

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

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

In our opinion, the accompanying statement of net assets sold presents fairly, in all material respects, the net assets of ABC Company as of June 8, 20X1, sold pursuant to the purchase agreement referred to in Note X, in conformity with accounting principles generally accepted in the United States of America.[c]

This report is intended solely for the information and use of the boards of directors and managements of ABC Company and XYZ Corporation and is not intended to be and should not be used by anyone other than these specified parties.[d]

Notes:

[a] If the auditors' client is not the party responsible for the financial statements on which the auditors are reporting (for example, when the auditors are engaged by the buyer to report on the seller's financial statements prepared in conformity with a buy-sell agreement, the party responsible for the financial statements may be the seller's management), the introductory paragraph should identify the responsible party.

[b] The report indicates what the special-purpose presentation is intended to present and refers to the note to the financial statements that describes the basis. The paragraph also states that the presentation is not intended to be a complete presentation of assets, liabilities, revenues, and expenses.

[c] The opinion relates to fair presentation in conformity with GAAP. If the statement differs from a complete financial statement in any material respect other than as necessary for the special purpose, the report should include the appropriate modifying language.

[d] The report includes a paragraph restricting use to those within the company and the third party with whom the company is negotiating directly.

EXPRESSING AN OPINION ON ONE OR MORE SPECIFIED ELEMENTS, ACCOUNTS, OR ITEMS OF A FINANCIAL STATEMENT

General

Auditors may be engaged to express an opinion on one or more specified elements, accounts, or items of a financial statement either as a separate engagement for that purpose or in conjunction with an audit of the related financial statements. Generally, auditors may express an opinion on specified elements, accounts, or items of a financial statement regardless of whether they have audited the related financial statements. However, the nature of some elements, accounts, and items is such that auditors must audit the related financial statements to have a reasonable basis for expressing an opinion on that element, account, or item. Such items include working capital, net assets, a provision for income taxes, profit participation, and income available for dividends. Elements, accounts, or items of a financial statement may be prepared in conformity with GAAP or with another basis of accounting, e.g., in conformity with the provisions of a contract, law, or government regulation.

Scope of Engagement

When auditors undertake to express an opinion on an element, account, or item of a financial statement, the adequacy of the scope of their auditing procedures and tests should be judged in relation to each element, account, or item on which they are reporting. Auditing procedures and tests applied in auditing the financial statements taken as a whole may not be adequate for expressing an opinion on an element, account, or item of the financial statements. As a result, an audit of one or more elements, accounts, or items of a financial statement is usually more extensive than if the same data were being examined in conjunction with the financial statements taken as a whole. In addition, many accounts are interrelated, e.g., plant and equipment and depreciation, and the auditors must consider accounts that are related to those on which they are reporting.

In engagements to report on elements, accounts, or items of financial statements, auditors should consider materiality in relation to each individual element, account, or item examined rather than to the financial statements taken as a whole.

Legal Interpretations

Occasionally, auditors may be requested to report on the accounting application of certain terms of a legal document, statute, or agreement. In those circumstances, it is usually advisable to obtain a legal interpretation from the client's counsel, if one has been retained. It is also advisable for auditors to refer to the interpretations in their reports.

Audits of Specified Elements in Conjunction with Audits of Financial Statements

Whenever an audit of specified elements, accounts, or items is made in conjunction with an audit of financial statements, auditors should report that fact. In addition, any modification of the auditor's report on the financial statements should be described if the modification is considered relevant to the presentation of specified elements, accounts, or items. If auditors issue an adverse opinion or disclaim an opinion on financial statements, they may report on elements, accounts, or items of those financial statements only if (a) the report on the elements, accounts, or items does not accompany the financial statements and (b) the report on the elements, accounts, or items does not encompass so much of the financial statements that it would be tantamount to issuing a piecemeal opinion.

Dating of Reports

If the audit of the specified elements, accounts, or items is made in conjunction with an audit of the financial statements taken as a whole, but the special report is to be dated after the date of the report on the financial statements, generally accepted auditing standards require completion of a subsequent events review with regard to the elements, accounts, or items on which the auditors are reporting.

Reporting

When audited in conjunction with financial statements, the specified elements, accounts, or items on which auditors are reporting may be presented either in the document that includes the financial statements and the auditor's report (provided that the auditors have not issued an adverse opinion or a disclaimer of opinion on the financial statements) or in a document accompanying it. Most auditors prefer that such information be presented in a separate document rather than in the document that includes the financial statements and auditor's report.

SAS No. 62 at AU 623.15 states that if the specified element, account, or item is presented on a basis other than generally accepted accounting principles or an other comprehensive basis of accounting, auditors should include an additional paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity and the parties to the contract, and is not intended to be and should not be used by anyone other than those specified parties. Reports on specified elements, accounts, or items presented on a regulatory basis of accounting, which is an OCBOA, also should be restricted.

Report in Conjunction with an Audit

When auditors report on their audit of specified elements, accounts, or items of a financial statement in conjunction with an audit of those financial statements, their report might take the following form.

INDEPENDENT AUDITOR'S REPORT

To ABC Company[a]

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of ABC Company for the year ended December 31, 20X1,[b] and have issued our report thereon dated February 14, 20X2.[c] We have also audited the accompanying schedule of (identify element, account, or item) of ABC Company[d] for the year ended December 31, 20X1. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this schedule based on our audit.

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

(Additional comments on significant interpretations made by the client or legal counsel relating to the provisions of relevant agreements or on the scope of additional procedures may be included, if necessary.)[f]

In our opinion, the schedule of (identify element, account, or item) referred to above presents fairly, in all material respects, (indicate what the element, account, or item presents) of ABC Company for the year ended December 31, 20X1, in conformity with (describe the basis of presentation).[g, h]

Notes:

[a] The report is addressed to the client. Special reports generally should not be addressed solely to third parties. In certain circumstances, it may be appropriate to address a special report to the client and a third party jointly. The report should not be addressed to stockholders unless it is intended for their use.

[b] When applicable, the report should indicate that the audit of the specified information was made in conjunction with the audit of the company's financial statements.

[c] The report refers to the auditor's report on the financial statements that include the element, account, or item covered by the report. If the auditors have modified their report on the financial statements, they should describe those modifications in their report on the extracted information, if the modification is considered relevant to the presentation.

[d] The report should specifically identify the element, account, or item of the financial statement on which the auditors are reporting. If the information is presented in a separate schedule, the report should refer to the title of the document, such as "Schedule of . . ."

[e] SAS No. 62 (AU 623) requires the standard SAS No. 58 (AU 508) scope paragraph (unless there is a scope limitation) even if some of the items do not seem to apply in the circumstances. For example, if the auditors report on a schedule of cash, there may be no "significant estimates" involved. Nonetheless, the scope paragraph should refer to "assessing . . . significant estimates." Revising the standard wording on an audit-by-audit basis might lead users to question the adequacy of the procedures applied.

[f] If necessary, the report should include an additional paragraph describing and indicating the source of any significant interpretations of the provisions of relevant agreements made by the client. In some circumstances, the client may request, or an agreement may require, that the audit report describe specified procedures applied in the audit of the information.

[g] The report includes the auditor's opinion about whether the specified element, account, or item is presented fairly on the basis indicated. The report should briefly describe the basis of accounting on which the information is presented; for example, GAAP or another basis specified in a contractual agreement. If the presentation is prepared in conformity with GAAP, the report should also include a reference to the country of origin for those accounting principles (for example, accounting principles generally accepted in the United States of America). If the presentation is not prepared in conformity with GAAP, the report should describe the basis on which the specified element is presented and, when applicable, any agreements specifying such basis. In addition, if the specified element is presented in conformity with an OCBOA, the report should include a statement that the basis of presentation is a comprehensive basis of accounting other than GAAP.

[h] The illustrative report assumes that the specified element, account, or item is presented on either a GAAP or OCBOA basis. However, if the basis of presentation is other than GAAP or OCBOA, SAS No. 62 at AU 623.15 requires an additional paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity and the parties to the contract, and is not intended to be and should not be used by anyone other than those specified parties. An example of such a paragraph, which should follow the opinion paragraph, is as follows:

> This report is intended solely for the information and use of the board of directors and management of ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

If the presentation is on a basis prescribed by a governmental regulatory agency (also an OCBOA), auditors should similarly restrict the use of the report.

Report on a Separate Engagement

When auditors are engaged to report on specified elements, accounts, or items of a financial statement, but they are not engaged to audit the financial statements, their report would look like the report issued in conjunction with an audit of financial statements except that the first sentence of the first paragraph would be omitted.

REPORTS ON COMPLIANCE WITH ASPECTS OF CONTRACTUAL AGREEMENTS OR REGULATORY REQUIREMENTS THAT ARE RELATED TO AUDITED FINANCIAL STATEMENTS

General

Auditors sometimes are engaged to prepare reports, based on their audit of the financial statements, for the purpose of reporting on compliance with provisions of contractual agreements or regulatory requirements. For example, loan agreements often impose a variety of covenants on borrowers involving matters such as payments into sinking funds, payments of interest, maintenance of a specified current ratio, restriction of dividend payments, and using the proceeds of sales of property. Auditors normally satisfy those requests by giving negative assurance with regard to the applicable covenants. That assurance may be given in a separate report or in one or more paragraphs of the auditor's report accompanying the financial statements. The assurance, however, should not be given unless auditors have audited the financial statements to which the contractual agreements or regulatory requirements relate.

Auditors' expression of negative assurance should specify that it is being given in connection with an audit of the financial statements. The auditors also should include a statement that the audit was not directed primarily toward obtaining knowledge regarding noncompliance. If the negative assurance is given in a separate report, the report should contain a paragraph stating that the financial statements have been audited, the date of the auditor's report, and whether the audit was conducted in accordance with GAAS.

Best practices indicate that all compliance reports should include the statement that the audit was not directed primarily toward obtaining knowledge of noncompliance. However, some clients may object to including that caveat when compliance reports on existing agreements have previously been issued without such language. If the client objects, the caveat may be omitted.

Before accepting an engagement to report on compliance with provisions of a contractual agreement, SAS No. 83, *Establishing an Understanding With the Client*, requires auditors to establish an understanding with the client about the services that they will provide. The understanding should include the specific matters to be covered in the report, the auditor's responsibilities, management's responsibilities, as well as limitations of the engagement (such as the fact that the audit is not directed toward obtaining knowledge of noncompliance). Under SAS No. 83, that understanding should be documented in the workpapers, preferably through an engagement letter.

The auditor's report on compliance should relate solely to matters such as well-defined financial ratios and other accounting data that can be measured from, or are relevant to, the audited financial statements and underlying accounting records. Auditors should not respond to vague definitions such as "no material adverse changes" or other legal or nonaccounting matters that are outside their competence as auditors.

SAS No. 62 at AU 623.20 requires an additional paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity and the parties to the contract or the regulatory agency with which the entity is filing the report, and is not intended to be and should not be used by anyone other than those specified parties. AU 623.20 notes that a restriction on the use of the report is necessary because the presentation's basis, assumptions, or purpose (which are contained in the contracts or regulatory provisions) are developed for and directed only to the parties to the contract or the regulatory agency that is responsible for the provisions.

Report Example

The following is an example of an auditor's separate report on compliance with contractual provisions.

INDEPENDENT AUDITOR'S REPORT

To ABC Company

We have audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheet of ABC Company as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated February 15, 20X2.[a]

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with the terms, covenants, provisions, or conditions of Sections X to XII, inclusive, of the Indenture dated July 21, 20X1, with First Bank insofar as they relate to accounting matters.[b] However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.[c]

This report is intended solely for the information and use of the boards of directors and management of XYZ Company and First Bank and is not intended to be and should not be used by anyone other than these specified parties.[d]

Notes:

[a] The report states that the auditors have audited the financial statements in accordance with generally accepted auditing standards and refers to the date of the report on the audited financial statements. If the auditor's report on the financial statements is qualified, the reasons for the qualification should be described.

[b] The report expresses negative assurance regarding the applicable provisions of the agreement and states that the assurance is being given in connection with the audit of the financial statements.

[c] The report includes a statement that the audit was not directed primarily toward obtaining knowledge regarding noncompliance.

[d] Use of the report is restricted to those within the entity and to parties to the agreement.

REPORTING ON FINANCIAL INFORMATION PRESENTED IN PRESCRIBED FORMS OR SCHEDULES

Auditors may be engaged to report on financial information presented in prescribed forms or schedules. Such forms generally are designed by the bodies with which they are to be filed and often prescribe the wording of an auditor's report. Many prescribed forms are unacceptable to auditors because the prescribed form of the auditor's report does not conform to applicable professional reporting standards. For example, the prescribed language of the report may call for assertions by the auditors that are not consistent with their function or responsibility.

Some report forms may be made acceptable by inserting wording; others may be made acceptable only by complete revision. When a prescribed form calls on auditors to make an assertion that they believe they are not justified in making, they should reword the form or attach a separate report. The reporting language discussed previously may be helpful in rewording unacceptable prescribed form reports when the basis of presentation is a comprehensive basis of accounting other than GAAP.

The following is an example of a letter to a regulatory agency explaining an alteration to a prescribed form report.

> Dear Sirs:
>
> A number of our clients are regularly requested to file Form XYZ. We believe that the financial statements as presented on Form XYZ are at variance with generally accepted accounting principles because. . .
>
> Also, the prescribed auditor's report differs from the opinion our firm ordinarily uses in such circumstances. (Give reasons, such as "omits scope paragraph" or "requires an opinion when no audit has been performed.")
>
> Therefore, we propose that Form XYZ be modified in accordance with the attached sample.
>
> Very truly yours,
>
> Firm's signature

REPORTING ON THE FINANCIAL STATEMENTS OF COMPANIES IN INSOLVENCY AND BANKRUPTCY PROCEEDINGS

General

Generally, the auditor's report on the financial statements of companies involved in insolvency and bankruptcy proceedings does not depart from general reporting guidance. In those circumstances, however, the following considerations may be relevant:

- Scope restrictions, such as inadequate accounting records or an inability to observe inventory or confirm accounts receivable, may be encountered more frequently than in audits of the financial statements of going concerns.
- Schedules of financial information in addition to the basic financial statements may be requested.
- Reports on elements, accounts, or items of financial statements or on the results of applying agreed-upon procedures may be requested.
- Modified reports because of uncertainties about the company's ability to continue as a going concern may be appropriate.

Basis of Accounting

An auditing interpretation at AU 9508.33–.37 states that a liquidation basis of accounting may be considered generally accepted accounting principles for companies in liquidation or for which liquidation appears imminent. Best practices indicate that auditors should issue a standard unqualified report on liquidation basis financial statements of such a company, provided that the liquidation basis of accounting has been properly applied and that adequate disclosures are made in the financial statements. In addition, auditors may include an additional paragraph in their report to emphasize that the financial statements are presented on a liquidation basis of accounting.

The financial statements of a prior period that were prepared on the basis of generally accepted accounting principles for going concerns might be presented along with liquidation basis statements. In that case, the report should include an explanatory paragraph stating that the company has changed the basis of accounting used to determine the amounts at which assets and liabilities are carried from the going concern basis to a liquidation basis.

When Does Liquidation "Appear Imminent"?

Auditors sometimes question what the phrase "appears imminent" means and at what point it becomes appropriate for a company to adopt the liquidation basis of accounting. While there is no authoritative guidance on this matter, best practices indicate the phrase implies that in certain circumstances it may be appropriate to adopt the liquidation basis of accounting before a formal plan of liquidation is approved. In fact, in some cases the use of the liquidation basis of accounting may be appropriate even though a formal liquidation plan is *never* approved or acted upon by a company's board of directors. Determining the point at which liquidation accounting should be adopted requires a high degree of professional judgment, and the decision should be based on careful consideration of the facts and circumstances. For example, if a company is in financial distress and begins selling significant operating assets or laying off significant numbers of employees, auditors may conclude that liquidation appears imminent even though a liquidation plan has not yet been formally approved. The liquidation basis of accounting may be appropriate in such circumstances.

Also, the auditor's consideration of whether the liquidation basis should be used is a matter that should be closely monitored throughout the subsequent events review conducted as part of the audit. SAS No. 1 (AU 560.07) notes that subsequent events affecting the realization of assets or the settlement of liabilities ordinarily will require adjustment of the financial statements because they typically represent the culmination of conditions that existed over a relatively long period of time. Thus, if a company decides to liquidate (or if the auditors conclude that liquidation is imminent) at a date after the balance sheet date but before the financial statements are issued, presentation of the financial statements on the liquidation basis of accounting should be considered. However, *compelling* evidence would be necessary to conclude that the liquidation is the culmination of conditions that existed at the balance sheet date. If compelling evidence is not present and the financial statements are not presented on the liquidation basis of accounting, best practices indicate that in most cases the auditor's report should be modified for a going concern uncertainty. Reporting guidance when a company in liquidation prepares its financial statements on the going concern basis is provided below.

Uncertainties

Financial statements presented on a liquidation basis may be affected by significant uncertainties with respect to the realizability of amounts at which assets are presented and the amounts that creditors will agree to accept in settlement of the obligations due them.

Disclosures in Liquidation Basis Statements

Auditors need to consider the adequacy of disclosure in financial statements prepared on the liquidation basis of accounting. When a company is in liquidation or liquidation appears imminent, best practices indicate that the notes to the financial statements should include the following:

- A note disclosing use of the liquidation basis and describing the tax effect of the liquidation. (Tax law requires gains from liquidation to be taxed on distribution.)
- A note stating the amounts and dates of any liquidating dividends paid or approved by the board of directors
- A note disclosing the termination of any major commitments or contracts, e.g., leases, pension plans, license agreements

Failure of a Company in Liquidation to Use Liquidation Accounting

As mentioned above, the auditing interpretation at AU 9508.33–.37 states that a liquidation basis of accounting "may be" considered GAAP for a company in liquidation. Best practices indicate that when a company is in liquidation, financial statements prepared on the going concern basis contemplated by GAAP are inappropriate since the carrying amount of assets and liabilities may be materially different than if reported on a liquidating basis. If adjustments are required but have not been made, an adverse opinion may be necessary.

Reporting by Companies in Reorganization under the Bankruptcy Code

SOP 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*, applies to a client that has filed a petition with the Bankruptcy Court and expects to reorganize as a going concern and to a client that has emerged from Chapter 11 under a confirmed plan. It does not apply to a client that is in liquidation under the Bankruptcy Code, i.e, a Chapter 7 bankruptcy or a liquidation under Chapter 11. In other words, SOP 90-7 (FASB ASC 852) applies to a client that will undergo a voluntary reorganization under Chapter 11. The liquidation basis of accounting applies to a client that voluntarily or involuntarily liquidates under Chapter 7.

Entering a reorganization proceeding does not ordinarily affect the application of GAAP in preparing financial statements. However, the financial statements for periods including and subsequent to filing the Chapter 11 reorganization petition should distinguish transactions and events that are directly associated with the reorganization from the ongoing operations of the business. In other words, a company in reorganization does not use a different basis of accounting, but through financial statement classification and disclosure, separates the effects of the reorganization from ongoing operations.

SOP 90-7 (FASB ASC 852) establishes financial reporting requirements for a company emerging from Chapter 11 reorganization. A company whose plan has been confirmed by the court and thereby has emerged from Chapter 11 may need to adopt *fresh-start* reporting. Under fresh-start reporting, assets are presented at reorganization values and liabilities, other than deferred taxes, are reported at present values. Deferred taxes are reported in conformity with GAAP.

Best practices indicate that auditors may issue a standard unqualified report on the financial statements of a company that has filed a reorganization petition under Chapter 11 or that has emerged from Chapter 11 as long as the company has complied with SOP 90-7 (FASB ASC 852), as amended, and there are no significant uncertainties about the company's ability to continue as a going concern. Under Chapter 11 reorganization, a company expects to emerge as a going concern. Filing a petition starts the reorganization proceeding. The court may confirm a reorganization plan, even if some classes of creditors or some stockholders oppose it, provided the plan meets standards of fairness required by Chapter 11. When a significant uncertainty exists concerning the confirmation of the plan, auditors should add an explanatory paragraph to their report that calls attention to the substantial doubt concerning the company's ability to continue as a going concern.

REPORTING ON THE APPLICATION OF ACCOUNTING PRINCIPLES TO A PARTICULAR TRANSACTION OR NEW FINANCIAL PRODUCT

General

Accountants occasionally receive requests from nonclients about the application of accounting principles to a particular transaction or new financial product. Such requests often arise when management wants a second opinion regarding the accounting treatment for a transaction for which there is little consensus or precedent. For example, management may be considering entering into a lease agreement for office space and, because of the complex terms of the transaction, it is not readily apparent whether the lease should be classified as a capital or operating lease. If the authoritative literature does not address the specific type of transaction, and few analogies or precedents exist, management may seek a second opinion about how the lease should be classified.

SAS No. 50, *Reports on the Application of Accounting Principles* (AU 625), as amended by SAS No. 97, gives guidance on reporting in situations such as those described in the preceding paragraph. SAS No. 50 (AU 625) provides guidance for preparing written reports to either principals to a transaction (e.g., management) or others (such as attorneys and bankers who may advise the principal) when accountants are asked to provide an opinion on one of the following:

a. The application of accounting principles to a specified transaction, either completed or proposed, involving facts and circumstance of a specific entity ("specific transaction")

b. The type of opinion that may be rendered on a specific company's financial statements (often such a request is made in connection with a proposal to obtain a new client)

SAS No. 97 amends SAS No. 50 to prohibit accountants from providing written reports on the application of accounting principles to hypothetical transactions (that is, those not involving facts and circumstances of a specific entity). Therefore, reporting to intermediaries (such as investment bankers who want an opinion on the accounting treatment of a new financial product) is not permitted unless the intermediary is acting for a specific entity.

Best practices indicate that SAS No. 50 (AU 625) is intended to apply to nonclients, except when accountants are rendering a proposal to retain the services of an existing client. The SAS states that it does not apply to:

a. Continuing accountants with respect to the specific entity whose financial statements they have been engaged to report on.

b. Engagements to provide litigation assistance.

c. Professional advice provided to other accountants in public practice.

d. Communications such as position papers prepared for the purpose of presenting views on an issue involving the application of an accounting principle or the type of opinion that may be rendered (unless the communication is intended to provide guidance for a specific entity or a specific transaction).

Oral Advice

Accountants often are asked to respond orally to questions about the application of accounting principles. Such situations may range from formal proposals to obtain new clients to informal discussions. SAS No. 50 (AU 625) applies to certain oral advice, specifically advice that will be used by a principal to a transaction as an important factor considered in reaching a decision. Since the SAS does not provide any guidance on how the accountants draw that conclusion (for example, it does not specify whether the principal's decision is limited to determining the proper accounting treatment or whether it includes other matters), generally that the best approach is to avoid giving *oral* advice to nonclients because of the greater possibility that oral advice may be misinterpreted or misused. However, accountants may be unable to avoid giving an oral response to a question about applying GAAP. In those situations, generally the accountants should first determine the circumstances under which the request has been made. In other words, they should try to ascertain matters such as who has made the request, how the advice will be used, the relevant facts and circumstances of the specific entity, and whether the entity's management is in disagreement with the continuing accountant. If the answers to those questions cause the accountants to believe that their advice will be used by a principal to the transaction as primary support for a decision, the accountants should follow the requirements of SAS No. 50. Otherwise, the accountants should decline to respond orally.

Summary of Standards

The standards fall into two general categories—performance standards and reporting standards. Similar to the general and fieldwork standards of GAAS, the performance standards focus on technical training, adequate planning and supervision, and accumulating sufficient information. SAS No. 50 at AU 625.07–.09 lists the following performance requirements:

- The reporting accountants should exercise due professional care in performing the engagement and should have adequate technical training and proficiency.
- The reporting accountants also should plan the engagement adequately, supervise the work of assistants, if any, and accumulate sufficient information to provide a reasonable basis for the professional judgment described in the report.
- The reporting accountants should consider the circumstances under which the written report or oral advice is requested, the purpose of the request, and the intended use of the written report or oral advice.
- The reporting accountants should apply the following procedures: (a) obtain an understanding of the form and substance of the transaction(s); (b) review applicable GAAP; (c) if appropriate, consult with other professionals or experts; and (d) if appropriate, apply research or other procedures to ascertain and consider the existence of creditable precedents or analogies.
- When evaluating accounting principles that relate to a specific transaction or determining the type of opinion that may be rendered on a specific company's financial statements (at the request of a principal or an intermediary acting for a principal), the reporting accountants should consult with the continuing accountants of the company to ascertain all the available facts relevant to forming a professional judgment. (However, see below for discussion about when consultation with the continuing accountant may not be required.)

Best practices indicate that the requirement for communication with continuing accountants is usually critical to forming a professional judgment about the appropriate accounting treatment of a transaction. The Company's management or others may not describe the transaction objectively, particularly if management is in disagreement with the continuing accountants. Continuing accountants may provide information such as the form and substance of the transaction, the company's treatment of similar transactions in the past, and the conclusion reached by the continuing accountants regarding the transaction or the opinion that would be rendered. SAS No. 50 (AU 625.09) indicates that the responsibilities of continuing accountants to respond to such inquiries are the same as those of predecessor auditors to respond to successor auditors. (See SAS No. 84 at AU 315.)

Under certain circumstances, consultation with the continuing accountant may not be required. An auditing Interpretation at AU 9625.01–.09, "Reports on the Application of Accounting Principles," issued in January 2005, indicates that accountants who are engaged as *advisory accountants* to assist management in recurring accounting or reporting functions may be asked to provide advice, but not an opinion, on the application of accounting principles or to help management develop an accounting position before discussing it with the auditors. Because of the nature of their services, advisory accountants may have full access to management and full knowledge of the form and substance of the proposed application and how management has applied similar transactions in the past. The Interpretation indicates that, in this situation, the advisory accountant may be able to overcome the requirement in SAS No. 50 to consult with the continuing accountant.

The reporting standards of SAS No. 50 at AU 625.10 require that the accountant's report be addressed to the requesting entity (for example, management or the board of directors of the entity) and include the following:

- A brief description of the nature of the engagement and a statement that the engagement was performed in accordance with applicable AICPA standards.
- Identification of the specific entity; a description of the transaction; a statement of the relevant facts, circumstances, and assumptions; and a statement about the source of the information.
- A statement describing the appropriate accounting principles (including the country of origin) to be applied to the transactions or the type of opinion that may be rendered on the entity's financial statements and, if appropriate, the reasons for the reporting accountant's conclusion.
- A statement that the responsibility for the proper accounting treatment rests with the preparers of the financial statements, who should consult with their continuing accountants.
- A statement that any change in the facts, circumstances, or assumptions presented may change the report on the application of accounting principles.
- A separate paragraph at the end of the report that includes the following:
  - A statement indicating that the report is intended solely for the information and use of the specified parties,
  - An identification of the specified parties, and
  - A statement that the report is not intended to be and should not be used by anyone other than the specified parties.

  However, this is not intended to preclude distributing the report to the continuing accountant.

Report Illustration

An example report, adapted from SAS No. 50 (AU 625.11), follows.

ACCOUNTANT'S REPORT

To ABC Company

We have been engaged to report on the appropriate application of accounting principles generally accepted in the United States of America to the specific transaction described below. This report is being issued to ABC Company for assistance in evaluating accounting principles for the described specific transaction. Our engagement has been conducted in accordance with standards established by the American Institute of Certified Public Accountants.

The facts, circumstances, and assumptions relevant to the specific transaction as provided to us by the management of ABC Company are as follows: [Description of transaction.]

[Text discussing generally accepted accounting principles.]

The ultimate responsibility for the decision on the appropriate application of accounting principles generally accepted in the United States of America for an actual transaction rests with the preparers of financial statements, who should consult with their continuing accountants. Our judgment on the appropriate application of accounting principles generally accepted in the United States of America for the described specific transaction is based solely on the facts provided to us as described above; should those facts and circumstances differ, our conclusion may change.

This report is intended solely for the information and use of the board of directors and management of ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. Of the following, which basis of accounting presents liabilities at the *discounted amount of cash to be paid*?

   a. Estimated current-value basis of accounting.

   b. Liquidation basis of accounting.

10. Reports on special-purpose financial statements that are neither GAAP nor OCBOA are required by SAS No. 62 at AU 623.29 to include a paragraph at the end of the report that states that the report is intended exclusively for the information and use of all the following **except**:

    a. Those within the entity.

    b. Parties to the contract.

    c. Parties the entity is negotiating with indirectly.

    d. Regulatory agency with which the report is being filed.

11. Which of the following statements concerning auditors' reports on specified elements, accounts, or items of a financial statement is correct?

    a. If the auditors were not engaged to audit the financial statements at the same time, the report would look exactly like the report issued in conjunction with an audit of financial statements.

    b. If the auditors were engaged to audit the financial statements at the same time, the specified elements, accounts, or items on which the auditors are reporting must be presented in the document that includes the financial statements and the auditors' reports.

    c. If the specified element, account, or item is presented on a basis other than GAAP or an OCBOA, auditors should include an additional paragraph stating that the report is intended solely for the information and use of only those within the entity

    d. If the auditor is reporting on specified elements, accounts, or items presented on a regulatory basis of accounting, which is another comprehensive basis of accounting, the auditor should not restrict the use of the report solely to the specified parties.

12. When auditors are engaged to report on financial information presented in prescribed forms or schedules, they sometimes are asked to make an assertion that they believe they are not justified in making. In this case the auditors should reword the form or attach a separate report. True or False?

    a. True.

    b. False.

13. SOP 90-7 (FASB ASC 852) applies to which of the following clients involved in bankruptcy?

    a. A client that is in a voluntary Chapter 7 bankruptcy.

    b. A client that is in liquidation under Chapter 11.

    c. A client that will undergo a voluntary reorganization under Chapter 11.

    d. A client that is in an involuntary Chapter 7 bankruptcy.

14. A company emerging from Chapter 11 reorganization may need to adopt *fresh-start* reporting. Under fresh-start reporting, which of the following are reported in conformity with GAAP?

    a. Assets.

    b. Liabilities other than deferred taxes.

    c. Deferred taxes.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. Of the following, which basis of accounting presents liabilities at the *discounted amount of cash to be paid*? **(Page 249)**

   a. Estimated current-value basis of accounting. [This answer is correct. The estimated current-value basis of accounting values assets and liabilities by the current-value measurement base considered appropriate for that item; therefore, liabilities are presented at the *discounted amount of cash to be paid*.]

   b. Liquidation basis of accounting. [This answer is incorrect. The liquidation basis of accounting presents assets at the amounts *expected to be realized in liquidation* and presents liabilities at amounts *expected to be paid to creditors*.]

10. Reports on special-purpose financial statements that are neither GAAP nor OCBOA are required by SAS No. 62 at AU 623.29 to include a paragraph at the end of the report that states that the report is intended exclusively for the information and use of all the following **except**: **(Page 249)**

    a. Those within the entity. [This answer is incorrect. The paragraph should state that the report is intended solely for the information and use of several parties, one being those within the entity so that other parties know the report is not intended for them.]

    b. Parties to the contract. [This answer is incorrect. Parties to the contract are one of the specified groups to be mentioned in the report as users of this information. The paragraph places limitations on whom the report is intended to reach.]

    c. Parties the entity is negotiating with indirectly. [This answer is correct. The paragraph should indicate that the report is intended solely for information and use by specified parties, including parties the entity is negotiating with *directly*, meaning parties with the ability to ask questions of management and negotiate the terms or structure of a transaction with management.]

    d. Regulatory agency with which the report is being filed. [This answer is incorrect. One of the parties that SAS No. 62 at AU 623.29 limits the use of special-purpose financial statements that are not GAAP or OCBOA is the regulatory agency with which the report is being filed. The report is not intended for others.]

11. Which of the following statements concerning auditors' reports on specified elements, accounts, or items of a financial statement is correct? **(Page 254)**

    a. If the auditors were not engaged to audit the financial statements at the same time, the report would look exactly like the report issued in conjunction with an audit of financial statements. [This answer is correct. In this case, the first sentence of the first paragraph would be omitted from the report. An example of the first sentence states "We have audited, in accordance with the standards generally accepted in the United States of America, the financial statements of ABC Company for the year ended December 31, 20X1, and have issued our report thereon dated February 14, 20X2." Instead the report would start with "We have audited the accompanying schedules of (identify element, account, or item) of ABC Company for the year ended December 31, 20X1."]

    b. If the auditors were engaged to audit the financial statements at the same time, the specified elements, accounts, or items on which the auditors are reporting must be presented in the document that includes the financial statements and the auditors' reports. [This answer is incorrect. There is a choice. The auditors can present the specified elements, accounts, or items this way or they may present them in a document accompanying the statements and report.]

c. If the specified element, account, or item is presented on a basis other than GAAP or an OCBOA, auditors should include an additional paragraph stating that the report is intended solely for the information and use of only those within the entity. [This answer is incorrect. The reports should be restricted not only for the information and use of those within the entity, but also the parties to the contract. The report should also state that the report is not intended to be and should not be used by anyone other than those specified parties.]

d. If the auditor is reporting on specified elements, accounts, or items presented on a regulatory basis of accounting, which is another comprehensive basis of accounting, the auditor should not restrict the use of the report solely to the specified parties. [This answer is incorrect. The exact opposite is true. Reports on specified elements, accounts, or items presented on a regulatory basis of accounting, which is an OCBOA, should be restricted so auditors are clear on whom the report is intended.]

12. When auditors are engaged to report on financial information presented in prescribed forms or schedules, they sometimes are asked to make an assertion that they believe they are not justified in making. In this case the auditors should reword the form or attach a separate report. True or False? **(Page 256)**

   a. True. [This answer is correct. Sometimes the prescribed forms are unacceptable to auditors because the prescribed form of the auditor's report does not conform to applicable professional reporting standards. Rewording the form or attaching a separate report is necessary when the assertions requested are not justified.]

   b. False. [This answer is incorrect. Some report forms may be made acceptable by inserting wording; others may be made acceptable only by complete revision. Rewording the form or attaching a separate report is necessary in this situation.]

13. SOP 90-7 (FASB ASC 852) applies to which of the following clients involved in bankruptcy? **(Page 258)**

   a. A client that is in a voluntary Chapter 7 bankruptcy. [This answer is incorrect. SOP 90-7 does not apply, but rather the liquidation basis of accounting applies to a client that voluntary liquidates under Chapter 7 bankruptcy laws.]

   b. A client that is in liquidation under Chapter 11. [This answer is incorrect. The liquidation basis of accounting applies to a client that is in Chapter 11 liquidation under the Bankruptcy Code rather than SOP 90-7.]

   c. A client that will undergo a voluntary reorganization under Chapter 11. [This answer is correct. SOP 90-7 (FASB ASC 852) applies to a client that has either filed a petition with the Bankruptcy Court and expects to reorganize as a going concern or to a client that has emerged from Chapter 11 under a confirmed plan.]

   d. A client that is in an involuntary Chapter 7 bankruptcy. [This answer is incorrect. A client that is in an involuntary Chapter 7 bankruptcy is subject to the liquidation basis of accounting and, therefore, not SOP 90-7.]

14. A company emerging from Chapter 11 reorganization may need to adopt *fresh-start* reporting. Under fresh-start reporting, which of the following are reported in conformity with GAAP? **(Page 258)**

   a. Assets. [This answer is incorrect. Under fresh-start reporting, assets are presented at reorganization values rather than GAAP.]

   b. Liabilities other than deferred taxes. [This answer is incorrect. Under fresh-start reporting, liabilities other than deferred taxes are reported at present values rather than GAAP.]

   c. Deferred taxes. [This answer is correct. Under fresh-start reporting, deferred taxes are reported in conformity with GAAP per SOP 90-7.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (GARTG093)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Financial statements that have been prepared in conformity with IFRS for use outside the United States are not considered OCBOA and should be reported on under:

   a. SAS No. 50.

   b. SAS No. 51.

   c. SAS No. 58.

   d. SAS No. 62.

2. When a statement of cash flows is presented by an entity in OCBOA presentations, it should be treated and reported on as:

   a. A basic financial statement.

   b. Supplemental information.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

3. Which disclosure listed below does **not** need to be disclosed in OCBOA financial statements?

   a. Related party transactions.

   b. Employee benefit plans.

   c. Effects of the difference between basis of presentation and GAAP.

   d. Subsequent events.

4. When financial statements are presented on an OCBOA and the auditor determines they are not presented fairly on the basis of accounting described, which of the following statements is accurate?

   a. The auditor's only choice is an adverse opinion.

   b. A separate explanatory paragraph is optional.

   c. The auditor's only choice is a qualified opinion.

   d. F*inancial position* should not be used in the report.

5. Which of the following is the appropriate form of report when reporting on financial statements prepared in conformity with the requirements or financial reporting provisions of a government regulatory agency?

   a. GAAP basis financial statements.

   b. OCBOA financial statements.

c. Report form depends on the use of the reports.

d. Do not select this answer choice.

6. FASB Interpretation No. (FIN) 48, "Accounting for Uncertainty in Income Taxes (FASB ASC 740)," prescribes how tax positions should be measured for those tax positions having a _______ percent chance of being sustained.

   a. Greater than 30%.

   b. Greater than 40%.

   c. 50% or greater.

   d. Greater than 50%.

7. AICPA Technical Practice Aid at TIS 1500.06 states that, "a variable interest entity that is not consolidated under the income tax basis of accounting is analogous to a ________ subsidiary that would be consolidated under GAAP but is not consolidated under the income tax basis of accounting because the threshold for consolidation under the Internal Revenue Code is 80% ownership."

   a. 50%-owned.

   b. 60%-owned.

   c. 75%-owned.

   d. Do not select this answer choice.

8. Which of the following circumstances would require auditors to add a consistency paragraph to their report for a change in accounting principle?

   a. Changes where disclosure is necessary due to a change in tax law.

   b. A change in the treatment of an item for income tax purposes when GAAP basis financial statements are presented.

   c. A change in the treatment of an item for income tax purposes when tax basis financial statements are presented.

   d. Do not select this answer choice.

9. The term *current-value* as it relates to the current-value basis of accounting is used to refer to all of the following methods used to determine value **except**:

   a. Current cost or current replacement cost (input price).

   b. Discounted cash flow (present value).

   c. Projected cash flow (adjusted value).

   d. Current market value (exit price).

10. The liquidation basis of accounting is considered GAAP in which of the following situations?

    a. A company that is in liquidation.

b. A company that is not in liquidation.

c. A company for which liquidation does not appear imminent.

d. Do not select this answer choice.

11. An auditor must audit the related financial statements to have a reasonable basis for expressing an opinion on certain elements, accounts, and items of a financial statement. Which of the following is one of those items?

    a. Plant and equipment.

    b. Schedule of cash.

    c. Depreciation.

    d. Income available for dividends.

12. Which of the following statements is accurate concerning reports on compliance with provisions of contractual agreements or regulatory requirements related to audited financial statements?

    a. Compliance reports should not include a statement indicating that the audit was not directed primarily toward obtaining knowledge of noncompliance.

    b. Solely at the auditor's discretion, compliance reports may include the statement that the audit was not directed primarily toward obtaining knowledge of noncompliance.

    c. Compliance reports may omit the statement that the audit was not directed primarily toward obtaining knowledge of compliance if the client objects, due to compliance reports on existing agreements having previously been issued without such language.

    d. Without exception, all compliance reports must include the statement that the audit was not directed primarily toward obtaining knowledge of noncompliance.

13. Which of the following considerations is **not** relevant regarding reporting on companies in insolvency and bankruptcy proceedings?

    a. Reports may be requested on the results of applying agreed-upon procedures or on elements, accounts, or items of financial statements.

    b. The auditor's report on the financial statements of companies involved in insolvency and bankruptcy proceedings usually departs from general reporting guidance.

    c. Schedules of financial information may be requested in addition to the basic financial statements.

    d. Modified reports may be appropriate due to uncertainties about the company's ability to continue as a going concern.

14. SAS No. 50, *Reports on the Application of Accounting Principles*, gives guidance on reporting in situations when an accountant receives a request from a nonclient about the application of accounting principles to a particular transaction. When does this SAS apply?

    a. Advice provided professionally to other public accountants.

    b. Litigation assistance engagements.

    c. Position paper presenting views on the type of opinion that may be rendered.

    d. Nonclients seeking a second opinion about a transaction for which there is little consensus or precedent.

Lesson 2: Other Special Reporting Areas

INTRODUCTION

Lesson 2 covers other special reporting areas not covered in Lesson 1 including, among others, reporting on applying agreed-upon procedures and consulting engagements, as well as attestation standards.

Learning Objectives:

Completion of this lesson will enable you to:

- Describe attestation standards including report illustrations and modifications.
- Describe reporting on applying agreed-upon procedures, prospective financial information, and pro forma information.
- Discuss compliance with requirements of laws, regulations, or rules and how they are applied.

ATTESTATION STANDARDS

General

Authoritative Literature. The attestation standards are codified and organized in the AT sections of the AICPA Professional Standards. The attestation standards include the following sections:

- AT 101—*Attest Engagements*. This AT section establishes a general framework for all attest engagements. Additional requirements for engagement performance and reporting for certain subject matter is provided in AT sections 201 through 701.

- AT 201—*Agreed-Upon Procedures Engagements*.

- AT 301—*Financial Forecasts and Projections.*

- AT 401—*Reporting on Pro Forma Financial Information.*

- AT 501—*An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements.*

- AT 601—*Compliance Attestation.*

- AT 701—*Management's Discussion and Analysis.* This AT section provides guidance related to the performance of attest engagements on management's discussion and analysis and applies primarily to public companies.

Hierarchy of SSAE Literature. Statement on Standards for Attestation Engagements No. 14, *SSAE Hierarchy*, (a) identifies the body of attest literature, (b) clarifies the authority of attest publications issued by the AICPA and others, and (c) specifies which attest publications practitioners *must comply with* and those that they *should be aware of* when conducting attest engagements. Within the body of attest literature, SSAE No. 14 identifies the following categories of attest publications:

- Statements on Standards for Attestation Engagements issued by the AICPA are the highest category of SSAE publications in the SSAE hierarchy. Practitioners who perform attest engagements must have sufficient knowledge of the SSAEs to identify those that apply to their attest engagements and should comply with those that apply. In rare circumstances when practitioners depart from a presumptively mandatory requirement in an SSAE, they must document their justification for the departure and how alternative procedures performed in the circumstances achieved the objectives of the requirement.

- Attestation interpretations are the second category of SSAE publications in the SSAE hierarchy. Practitioners should be aware of and consider interpretative publications that apply to their attest engagements. If practitioners do not apply applicable guidance in attestation interpretations, they should be prepared to explain how they complied with the SSAE provisions addressed by the interpretations.

- Other attest publications are the lowest level of SSAE publications in the SSAE hierarchy. Other attestation publications have no authoritative status, however, they may help practitioners understand and apply the SSAEs. Other attestation publications include attestation articles in the *Journal of Accountancy*, other professional journals, and the AICPA *CPA Letter*, continuing professional education programs and other instructional materials, textbooks, guidebooks, attest programs and checklists, and other attestation publications from state CPA societies, other organizations, and individuals.

Definition of an Attest Engagement. AT 101 defines an *attest engagement* as one in which a practitioner *is engaged to issue or does issue an examination, a review, or an agreed-upon procedures report on subject matter, or an assertion about the subject matter, that is the responsibility of another party*. An assertion is any declaration or set of declarations about whether the subject matter is based on or in conformity with selected criteria. The subject matter of an attest engagement may be as of a point in time or for a period of time.

Engagements such as those listed below are *not* attest engagements unless they are modified to fit the definition above:

- Engagements performed in accordance with Statements on Auditing Standards.
- Engagements performed in accordance with Statements on Standards for Accounting and Review Services.
- Engagements performed in accordance with the Statement on Standards for Consulting Services, such as engagements in which the practitioner's role is solely to assist the client, for example, acting as the company accountant in preparing information other than financial statements, or engagements in which the practitioner is engaged to testify as an expert witness in accounting, auditing, taxation, or other matters, given certain stipulated facts.
- Engagements in which practitioners are engaged to advocate a client's position, for example, tax matters being reviewed by the Internal Revenue Service.
- Engagements in which practitioners prepare a client's tax return or provide tax advice.

The attestation standards are intended to provide a broad framework for a variety of services. The standards identify three different levels of attest services that vary in their levels of assurance:

a. *Examination*—the highest level of service, provides an opinion.

b. *Review*—a moderate level of service, provides negative assurance.

c. *Agreed-upon Procedures*—provides a report of findings based on specific procedures.

The nature, timing, and extent of attest procedures vary depending on the service practitioners provide. A high level of assurance (an *examination*) requires more extensive procedures, and a lower level of assurance (a *review* or *agreed-upon procedures*) requires less extensive procedures. (The general framework provided in AT 101 applies to agreed-upon procedures engagements. However, application of the attestation standards to agreed-upon procedures engagements is provided in AT 201, *Agreed-Upon Procedures Engagements*.)

Practitioners who perform attest engagements should issue a report on the subject matter or the assertion, or withdraw from the engagement. If the practitioner reports on the assertion, the assertion should be bound with or accompany the practitioner's report or should be clearly stated in the report. Practitioners should be aware that if they issue a report that is similar to an examination, review, or agreed-upon procedures attest report, it could be inferred that the report is an attest report and that the engagement is therefore subject to the attestation standards. Therefore, reports on engagements that are not performed under the attestation standards (such as consulting reports) should be clearly distinguishable from the reports described below.

The Need for a Written Assertion. Practitioners may report on a written assertion or they may report directly on the subject matter. (In addition, practitioners can examine an assertion but report directly on the subject matter.) Regardless of the form of report, however, in an examination or review engagement practitioners should ordinarily obtain a written assertion from the responsible party (that is, the person responsible for the subject matter). If a written assertion is not obtained in an examination or review engagement, the practitioner should not report on the assertion. However, the practitioner may still report on the subject matter. In that case, the practitioner should consider the effects of the failure to obtain a written assertion on his or her ability to gather sufficient evidence to form a conclusion about the subject matter. In any case, failure to obtain a written assertion will result in either modifications to the report or the inability to complete the engagement as discussed in the following paragraph.

When the practitioner's client is *not* the responsible party and a written assertion is not obtained, the practitioner may conclude that he or she is able to gather sufficient evidence to form a conclusion about the subject matter. In that case, the practitioner may issue an unqualified opinion or a standard review report on the subject matter, but the use of the report should be restricted. When the practitioner's client *is* the responsible party, failure to obtain a written assertion constitutes a client-imposed scope limitation sufficient to preclude an unqualified report. In an examination engagement, the practitioner should modify his or her report for the scope limitation and the use of the report should be restricted. In a review engagement, the client-imposed scope limitation results in an incomplete review and the practitioner should withdraw from the engagement.

Criteria. Criteria are the standards or benchmarks against which practitioners evaluate the subject matter. Criteria used to evaluate the subject matter must be *suitable* and *available* to all users. Some criteria may be appropriate for only a limited number of parties who either participated in establishing the criteria or who can be presumed to have an adequate understanding of the criteria. When criteria are appropriate only for a limited number of parties, the use of the practitioner's report should be restricted to those specified parties who either participated in establishing the criteria or who can be presumed to have an adequate understanding of the criteria. In addition, if the criteria are only available to specified parties, such as the terms of a contract available only to parties to the contract, the practitioner's report should be restricted to those parties who have access to the criteria.

Representation Letter. In an examination or review engagement, the practitioner should consider obtaining a representation letter from the responsible party and, if the client is not the responsible party, from the client. However, a representation letter is not required. If the responsible party or the client refuses to furnish a representation letter requested by the practitioner, the practitioner should consider the effects on his or her ability to gather sufficient evidence to form a conclusion about the subject matter. Refusal to furnish representations the practitioner considers necessary to form a conclusion about the subject matter is a scope limitation sufficient to preclude an unqualified report. Such a refusal ordinarily causes the practitioner to disclaim an opinion or withdraw from an examination engagement, unless he or she concludes a qualified opinion is appropriate because of the nature of the representations not obtained or the circumstances surrounding the refusal. The practitioner also should consider the effects of the refusal on his or her ability to rely on other representations. When such a scope limitation exists in a review engagement, the review is considered incomplete and the practitioner should withdraw from the engagement.

Standards of Reporting

AT 101 provides the standards of reporting applicable to all attest engagements. According to AT 101, attest reports should:

a. *Identify the Subject Matter or the Assertion and State the Character of the Engagement.* Practitioners who perform attest engagements should issue a report on the subject matter or the assertion, or withdraw from the engagement. If the practitioner reports on the assertion, the assertion should be bound with or accompany the practitioner's report or should be clearly stated in the report. Practitioners may also examine an assertion but express their opinion directly on the subject matter.

b. *State the Practitioner's Conclusion about the Subject Matter or the Assertion in Relation to the Criteria.* If there are material misstatements or deviations from the criteria, the practitioner should modify the report and ordinarily express his or her conclusion directly on the subject matter, not on the assertion. If the practitioner reports on subject matter or an assertion covering dates or periods during which criteria have changed, he or she should determine that the criteria are clearly stated or described for each of the dates or periods and the changes are adequately disclosed.

c. *State the Practitioner's Significant Reservations about the Engagement, the Subject Matter, or the Assertion.*

d. *Restrict the Use of the Report to Specified Parties in Certain Circumstances.* Use of the report should be restricted when:

- The criteria are appropriate only for a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria.
- The criteria are available only to specified parties.
- The practitioner is reporting on subject matter and a written assertion has not been provided by the responsible party.
- The report is on an agreed-upon procedures engagement.

Report Illustrations

Examination Report. The form of the practitioner's examination report will vary depending on whether the practitioner expresses an opinion on the assertion or the subject matter. Reports expressing an opinion may be qualified or modified for some aspect of the subject matter, the assertion, or the engagement. In addition, practitioners may wish to emphasize certain matters in the report. Depending on the form of report, the practitioner's examination report should include the following elements:

a. A title that includes the word *independent*.

b. Identification of the assertion (or the subject matter) and the responsible party. (When reporting on an assertion, and the assertion does not accompany the practitioner's report, the first paragraph of the report should also state the assertion.)

c. A statement that the assertion (or the subject matter) is the responsibility of the responsible party.

d. A statement that the practitioner's responsibility is to express an opinion on the assertion (or the subject matter) based on his or her examination.

e. A statement that the examination was conducted in accordance with "attestation standards established by the American Institute of Certified Public Accountants," and, accordingly, included procedures considered necessary in the circumstances.

f. A statement that the practitioner believes the examination provides a reasonable basis for his or her opinion.

g. The practitioner's opinion on whether (a) the assertion is presented (or fairly stated), in all material respects, based on the criteria or (b) the subject matter is based on (or in conformity with) the criteria in all material respects.

h. A statement restricting the use of the report to specified parties in certain circumstances.

i. The manual or printed signature of the practitioner's firm.

j. The date of the examination report.

Illustrative Examination Report. Presented below is an illustration of an examination report based on the guidance in SSAE No. 10 (AT 101). The basic format of the report would be used to report on an examination engagement if no specific report form has been prescribed in other authoritative literature. (SASs would be followed for reports on audits of historical financial statements; AT 301 and AT 401 would be followed for reports on an examination of prospective financial information or pro forma financial information; AT 501 would be followed for reports on an integrated examination (audit) of the effectiveness of an entity's internal control over financial reporting that is integrated with an audit of its financial statements; and AT 601 would be followed for reports on an examination of an entity's compliance with specified requirements.) The following example assumes the practitioner expresses an opinion on the subject matter (rather than the assertion), suitable criteria exist and are available to all users, and a written assertion has been obtained from the responsible party.

INDEPENDENT ACCOUNTANT'S REPORT

To XYZ Fund[a]

We have examined the accompanying Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 20X1. XYZ Fund's management is responsible for this statement.[b] 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 supporting the Statement of Investment Performance Statistics and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the subject matter.]

In our opinion, the Statement of Investment Performance Statistics referred to above presents, in all material respects, the investment performance of XYZ Fund for the year ended December 31, 20X1 based on the measurement and disclosure criteria set forth in Note 1.[c]

Notes:

[a] The report ordinarily should be addressed to the client. In this example, the client is also the responsible party.

[b] When the practitioner expresses an opinion on the subject matter, if a written assertion is not provided by the responsible party, the introductory paragraph of the examination report should include a statement to that effect. The following sentence can be added after the second sentence of the paragraph:

> XYZ Fund's management did not provide us a written assertion about its Statement of Investment Performance Statistics for the year ended December 31, 20X1.

When a written assertion has not been received from the responsible party, who is also the client, the failure to obtain a written assertion results in a scope limitation that would cause the practitioner to modify the opinion. Because the refusal to furnish a written assertion from the client is equivalent to a client-imposed scope limitation, practitioners ordinarily should disclaim an opinion or withdraw from the engagement. If the responsible party is not the client, the practitioner may be able to conclude that there is sufficient evidence to form a conclusion about the subject matter. In any event, the practitioner also should restrict the use of the report.

[c] If the criteria used in evaluating the subject matter are appropriate for only a limited number of parties or are available only to specified parties, use of the practitioner's report should be restricted. In that case, the following restricted-use paragraph can be added at the end of the report:

> This report is intended solely for the information and use of XYZ Fund and [identify other specified parties] and is not intended to be and should not be used by anyone other than these specified parties.

Review Report. The form of the practitioner's review report will vary depending on whether the practitioner provides negative assurance on the assertion or the subject matter. Depending on the form of report, the practitioner's review report should include the following elements:

a. A title that includes the word *independent*.

b. Identification of the assertion (or the subject matter) and the responsible party. (When reporting on an assertion, and the assertion does not accompany the practitioner's report, the first paragraph of the report should also state the assertion.)

c. A statement that the assertion (or the subject matter) is the responsibility of the responsible party.

d. A statement that the review was conducted in accordance with "attestation standards established by the American Institute of Certified Public Accountants."

e. A statement that a review is substantially less in scope than an examination, the objective of which is an expression of opinion on the assertion (or the subject matter), and a disclaimer of opinion on the assertion (or the subject matter).

f. A statement about whether the practitioner is aware of any material modifications that should be made to (a) the assertion for it to be presented (or fairly stated), in all material respects, based on (or in conformity with) the criteria or (b) the subject matter for it to be based on (or in conformity with), in all material respects, the criteria, other than those modifications, if any, indicated in his or her report.

g. A statement restricting the use of the report to specified parties in certain circumstances.

h. The manual or printed signature of the practitioner's firm.

i. The date of the review report.

Illustrative Review Report. Presented below is an illustration of a review report based on the guidance in SSAE No. 10 (AT 101). The basic format of the report would be used to report on a review engagement if no specific report form has been prescribed in other existing authoritative literature. (SSARS would be followed for reports on reviews of historical financial statements and AT 401 would be followed for reports on reviews of pro forma financial information.) The following example assumes the practitioner provides negative assurance on the subject matter (rather than the assertion), suitable criteria exist and are available to all users, and a written assertion has been obtained from the responsible party.

INDEPENDENT ACCOUNTANT'S REPORT

To XYZ Fund[a]

We have reviewed the accompanying Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 20X1. XYZ Fund's management is responsible for this statement.[b]

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective which is the expression of an opinion on the Statement of Investment Performance Statistics. Accordingly, we do not express such an opinion.

[Additional paragraph(s) may be added to emphasize certain matters relating to the attest engagement or the subject matter.]

Based on our review, nothing came to our attention that caused us to believe that the Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 20X1 is not presented, in all material respects, in conformity with the measurement and disclosure criteria set forth in Note 1.[c]

Notes:

[a] The report ordinarily should be addressed to the client. In this example, the client is also the responsible party.

[b] When the practitioner provides negative assurance on the subject matter, if a written assertion is not provided by the responsible party, the introductory paragraph of the review report should include a statement to that effect. The following sentence can be added after the second sentence of the paragraph:

> XYZ Fund's management did not provide us a written assertion about its Statement of Investment Performance Statistics for the year ended December 31, 20X1.

In addition, if the responsible party is *not* the client, the use of the report should be restricted. If the responsible party *is* the client, the failure to obtain a written assertion constitutes a scope limitation that precludes the practitioner from completing and reporting on the review engagement. In that case, the practitioner should withdraw from the engagement without issuing a report.

[c] If the criteria used in evaluating the subject matter are appropriate for only a limited number of parties or are available only to specified parties, use of the practitioner's report should be restricted. The following restricted-use paragraph can be added at the end of the report:

> This report is intended solely for the information and use of XYZ Fund and [Identify other specified parties.] and is not intended to be and should not be used by anyone other than these specified parties.

Report Modifications

General. The practitioner's examination or review report states the practitioner's conclusion about the assertion or the subject matter in relation to the criteria. If there are material misstatements or deviations from the criteria, the practitioner should modify the report and ordinarily express his or her conclusion directly on the subject matter, not on the assertion. Practitioners also may wish to emphasize certain matters in the report. In addition, the practitioner's report should state all of the practitioner's significant reservations about the engagement, the subject matter, or the assertion.

Scope Limitations. Reservations about the engagement may include limitations on the scope of the engagement, whether imposed by the client or by other circumstances. Scope limitations may require the practitioner to qualify his or her assurance, disclaim any assurance, or withdraw from the engagement.

In an examination engagement, the practitioner's decision to issue a qualified opinion, disclaim an opinion, or withdraw from the engagement because of a scope limitation depends on the nature and magnitude of the potential effects of the scope limitation and their significance to the subject matter or the assertion. When restrictions that significantly limit the scope of the engagement are imposed by the client or the responsible party, the practitioner ordinarily should disclaim an opinion or withdraw from the engagement. The reasons for a qualification or disclaimer should be described in the practitioner's report. When the client is the responsible party and does not provide the practitioner with a written assertion, that is considered a scope limitation sufficient to preclude an unqualified opinion.

When a scope limitation exists in a review engagement, such that the practitioner is unable to perform the procedures necessary to achieve the limited level of assurance contemplated by a review, the review is incomplete and the practitioner should not report on the engagement. In that case, the practitioner should withdraw. When the client is the responsible party and does not provide the practitioner with a written assertion, that is considered a scope limitation sufficient to preclude the practitioner from completing and reporting on the review engagement.

Material Misstatements. Reservations about the subject matter or the assertion include reservations about conformity or fair presentation in relation to the criteria, such as material misstatements related to measurement, form, content, or underlying assumptions. Practitioners also may have reservations about the adequacy of disclosures of significant matters. In an examination engagement, those reservations may result in either a qualified or adverse opinion, depending on materiality. In a review engagement, if the subject matter or the assertion is not modified to correct for any material misstatements, the attestation standards permit the practitioner to report as long as the problem is communicated in the report. However, if there are material misstatements or deviations from the criteria, the practitioner should report directly on the subject matter, not on the assertion.

Restricted-use Reports. Use of the practitioner's report should be restricted to specified parties when the conditions in the fourth standard of reporting outlined earlier in this lesson exist. A restricted-use report should alert readers to the restriction by indicating that the report is not intended to be and should not be used by anyone other than the specified parties. In addition, when the practitioner is reporting on subject matter and a written assertion has not been obtained from the responsible party, the introductory paragraph of the restricted-use report should include a statement to that effect, such as "XYZ Company's management did not provide us a written assertion about [Identify the subject matter.]."

A restricted-use attest report should contain a separate paragraph at the end of the report that (a) indicates that the report is intended solely for the information and use of the specified parties, (b) identifies the specified parties, and (c) states that the report is not intended to be and should not be used by anyone other than the specified parties. An example of such a paragraph follows:

> This report is intended solely for the information and use of [the specified parties] and is not intended to be and should not be used by anyone other than these specified parties.

This language is also appropriate when the restricted-use report is required by law or regulation to be made available to the public as a matter of public record.

If a practitioner issues a single combined report that covers both matters that require a restriction on use and matters that are appropriate for general use, the use of the single combined report should be restricted. If a separate restricted-use report is included in a document that also includes a general-use report, the intended use of the reports is not affected. The restricted-use report remains restricted and the general-use report remains appropriate for general use. In addition, practitioners are not precluded from restricting the use of any report that may otherwise be appropriate for general use.

Subsequent Events. If practitioners become aware of events or transactions that occur after the period addressed by their report but before the date of the report that have a material effect on the subject matter, they should consider adding information regarding the subsequent event to their report. If, after the date of their report, practitioners become aware of conditions that existed at that date that might have affected their report had they been aware of them, they should consider the guidance in AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

Other Information in Client-prepared Documents That Contain the Practitioner's Attest Report

An entity might publish various documents that contain other information in addition to the practitioners' report on subject matter or an assertion about the subject matter. The practitioner or other practitioners might have performed procedures and issued a report on some or all of such other information. The practitioners should read the other information not covered by their report or the report of the other practitioners and consider whether it, or the manner of its presentation, is materially inconsistent with the information appearing in the practitioner's report or whether such information contains a material misstatement of fact.

Material Inconsistency. If the practitioners believe that the other information is inconsistent with the information appearing in the practitioner's report, they should consider whether the practitioner's report requires revision. If they conclude that the practitioner's report does not require revision, they should request management to revise the other information. If management does not revise the other information to eliminate the inconsistency, the practitioners should consider other actions, such as:

- revising their report to include an explanatory paragraph describing the material inconsistency,
- withholding the use of their report in the document, or

- withdrawing from the engagement.

Material Misstatement of Fact. If the practitioners believe the other information contains a material misstatement of fact, they should discuss the matter with management. The practitioners should realize that they might not possess the expertise to assess the validity of the statement. Also, they should consider whether standards exist by which to assess the manner of presentation of the information and whether there might be valid differences of opinion. If the practitioners conclude that a material misstatement exists, they should propose that management consult with some other party whose advice might be useful, such as the entity's legal counsel.

If, after discussing the matter, the practitioners conclude that a material misstatement of fact remains, their action should depend on the circumstances. They should, however, consider the following steps:

- Notifying the entity's management and those charged with governance in writing of their views concerning the information.

- Consulting their legal counsel about further action.

Applicability to Engagements Subject to Other Standards

The fact that an engagement is an attest engagement does not override the applicability of other standards. A practitioner engaged to perform an engagement subject to Statements on Auditing Standards or Statements on Standards for Accounting and Review Services should follow such standards. In addition, the attestation standards are not a substitute for GAAS. Thus, it generally would not be appropriate for an auditor to refer to the attestation standards in an engagement involving financial statements (such as financial statements that are neither GAAP nor OCBOA).

Some engagements may include both attest services and consulting services. The types of engagements that are most likely to blend attest services and consulting services are those involving prospective information (financial forecasts or projections) and those involving internal control. Note that the portion of the engagement not covered by SASs or other attestation standards would be subject to the Statement on Standards for Consulting Services, and a practitioner would have to comply with both SSCS No. 1 (CS 100) and the applicable SAS or attestation standards in the same engagement.

For example, reporting on a financial forecast or projection is often a part of a larger consulting engagement, such as a feasibility study or business acquisition study, that has as its principal objective providing advice to the client. The attestation part of the engagement, however, would still be subject to the requirements of the Statements on Standards for Attestation Engagements at AT 301, *Financial Forecasts and Projections*.

Reporting on all or part of an entity's internal control is often a part of a larger consulting engagement involving asset protection and control, accounting systems, or information systems. The reporting on internal control as part of the engagement, however, might still be subject to the SASs or other attestation standards.

In deciding whether a consulting service contains some elements of an attestation service, a practitioner should consider the reasonable inferences that may be drawn from any written report as well as whether that report expresses a conclusion on subject matter, or an assertion about the subject matter, that is the responsibility of another party. AT 101.06 states:

> Any professional service resulting in the expression of assurance must be performed under AICPA professional standards that provide for the expression of such assurance. Reports issued by a practitioner in connection with other professional standards should be written to be clearly distinguishable from and not to be confused with attest reports. For example, a practitioner performing an engagement which is intended solely to assist an organization in improving its controls over the privacy of client data should not issue a report as a result of that engagement expressing assurance as to the effectiveness of such controls. Additionally, a report that merely excludes the words, ". . . was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants . . ." but is otherwise similar to an examination, a review or an agreed-upon procedures attest report may be inferred to be an attest report.

For example, a report on an entity's internal control that describes tests applied to pertinent internal control activities for achieving control objectives, and indicates no deficiencies in operating effectiveness, could reasonably be expected to provide assurance on the achievement of control objectives. A consulting service that is limited to providing the client with recommendations and advice is not an attest engagement. The applicability of the attestation standards is not, however, determined by the subject matter of the engagement or the desires of the client. Regardless of the client's desires or the subject matter of the engagement, the service is an attest engagement if the practitioner is engaged to issue or issues an examination, review, or agreed-upon procedures report on the subject matter (or an assertion about the subject matter).

When the practitioner determines that an attest service is to be provided as part of a consulting engagement, he or she should explain the differences between the two types of engagements to the client. The practitioner should reach an understanding with the client that the attest portion of the engagement will be performed in accordance with the attestation standards. In addition, separate reports should be issued on the attest engagement and the consulting engagement. If the reports are included in the same binder, the report on the attest engagement should be clearly identified and segregated from the report on the consulting engagement. To avoid the inference that the consulting service is an attest engagement, the practitioner should be careful not to structure the consulting report like an attest report.

Do the Attestation Standards Apply to Litigation Services?

The applicability of the attestation standards to litigation services is discussed in two attestation Interpretations at AT 9101.34–.37. The Interpretation at AT 9101.36–.37 states that the attestation standards apply only when practitioners are engaged to issue or do issue an examination, review, or agreed-upon procedures report on subject matter (or an assertion about subject matter), that is the responsibility of another party.

The Interpretation at AT 9101.34–.35 states that the attestation standards do not apply when the litigation services are rendered in connection with the resolution of disputes between parties involved in pending or potential formal legal or regulatory proceedings before a "trier of fact" (for example, a judge, arbitrator, or mediator), and when one of the following occurs:

a. The practitioners have not been engaged to issue and do not issue an examination, review, or agreed-upon procedures report on subject matter (or a related assertion) that is the responsibility of another party.

b. The practitioners are serving as expert witnesses.

c. The practitioners are the triers of fact or acting on behalf of them.

d. The practitioners' work under the rules of the proceedings is subject to challenge and detailed analysis by all parties to the dispute.

e. The practitioners are engaged by an attorney to do work that is protected under the attorney's work product privilege and not to be used for any other purpose.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. The AICPA Professional Standards have the attestation standards codified and organized. If an auditor refers to SSAE No. 10, AT 401, guidance is provided covering reporting on which of the following?

    a. Pro forma financial information.

    b. Internal control.

    c. Forecasts and projections.

    d. Agreed-upon procedures engagements.

16. SSAE No. 14, SSAE Hierarchy, identifies several categories of attest publications. Which of the following is the second category of SSAE publications in the SSAE hierarchy?

    a. Attestation articles in the *Journal of Accountancy.*

    b. Attestation interpretations.

    c. Statements on Standards for Attestation Engagements.

    d. The AICPA *CPA Letter.*

17. Which level of service identified in the attestation standards affords a *moderate* level of service or assurance?

    a. Assertion.

    b. Examination.

    c. Review.

    d. Agreed-upon Procedures.

18. The form of which of the following report illustrations will vary depending on whether the practitioner expresses an opinion on the assertion or on the subject matter?

    a. Examination Report.

    b. Review Report.

19. Which of the following situations might cause the practitioner to withdraw from the engagement?

    a. Practitioner's reservations concerning the adequacy of disclosures of significant matters in an examination engagement.

    b. Practitioners determine that the subject matter or the assertion in a review engagement is not modified to correct for any material misstatements.

    c. When the practitioner determines that restrictions that significantly limit the scope of an examination engagement are imposed by the client.

20. Which of the following is often a part of a larger consulting engagement involving information systems?

    a. Reporting on part or all of an entity's internal control system.

    b. Reporting on a financial projection or forecast.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. The AICPA Professional Standards have the attestation standards codified and organized. If an auditor refers to SSAE No. 10, AT 401, guidance is provided covering reporting on which of the following? **(Page 271)**

    a. Pro forma financial information. [This answer is correct. AT 401 of SSAE No. 10 is titled *Reporting on Pro Forma Financial Information*, and hence, should be followed for reports on pro forma financial information.]

    b. Internal control. [This answer is incorrect. Reporting on internal control is addressed in AT 501 of SSAE No. 10.]

    c. Forecasts and projections. [This answer is incorrect. Reporting on forecasts and projections is addressed in AT 301 of SSAE No. 10.]

    d. Agreed-upon procedures engagements. [This answer is incorrect. AT 201 of SSAE No. 10 addresses reporting on agreed-upon procedures engagements.]

16. SSAE No. 14, *SSAE Hierarchy*, identifies several categories of attest publications. Which of the following is the *second* category of SSAE publications in the SSAE hierarchy? **(Page 271)**

    a. Attestation articles in the *Journal of Accountancy.* [This answer is incorrect. Attestation articles in the *Journal of Accountancy* are identified in SSAE No. 14 as being included in the category called "other attest publications" and are the *lowest* level of SSAE publications in the SSAE hierarchy.]

    b. Attestation interpretations. [This answer is correct. Attestation interpretations are identified in SSAE No. 14 as the *second* category of SSAE publications in the SSAE hierarchy. Practitioners should be aware of and consider interpretative publications that apply to their attest engagements. If practitioners do not apply applicable guidance in attestation interpretations, they should be prepared to explain how they complied with the SSAE provisions addressed by the interpretations.]

    c. Statements on Standards for Attestation Engagements. [This answer is incorrect. Statements on Standards for Attestation Engagements are the *highest* category of SSAE publications in the SSAE hierarchy.]

    d. The AICPA *CPA Letter.* [This answer is incorrect. The AICPA *CPA Letter* is one of several publications in the category identified as "other attest publications" and is among the *lowest* level of SSAE publications in the SSAE hierarchy.]

17. Which level of service identified in the attestation standards affords a *moderate* level of service or assurance? **(Page 272)**

    a. Assertion. [This answer is incorrect. Assertion is not one of the levels of service identified in the attestation standards.]

    b. Examination. [This answer is incorrect. Examination is identified in the attestation standards as the highest level of service because it must include an opinion which requires extensive procedures.]

    c. Review. [This answer is correct. Review is identified in the attestation standards as a moderate level of service because it only provides negative assurance.]

    d. Agreed-upon Procedures. [This answer is incorrect. Agreed-upon procedures is identified in the attestation standards as being the lowest level of service because it provides merely a report of findings based on specific procedures and requires less extensive procedures.]

18. The form of which of the following report illustrations will vary depending on whether the practitioner expresses an opinion on the assertion or on the subject matter? **(Page 274)**

    a. **Examination Report. [This answer is correct. The form of the examination report will vary depending on whether the practitioner expresses an opinion on the assertion or on the subject matter. The practitioner's opinion will be on whether (a) the assertion is presented in all material respects, based on the criteria or (b) the subject matter is based on the criteria in all material respects.]**

    b. Review Report. [This answer is incorrect. The form of the review report will vary depending on whether the practitioner provides negative assurance (not an opinion) on the assertion or the subject matter.]

19. Which of the following situations might cause the practitioner to withdraw from the engagement? **(Page 277)**

    a. Practitioner's reservations concerning the adequacy of disclosures of significant matters in an examination engagement. [This answer is incorrect. Practitioners reservations concerning the adequacy of disclosures of significant matters in an examination engagement may result in either a qualified or adverse opinion, depending on materiality.]

    b. Practitioners determine that the subject matter or the assertion in a review engagement is not modified to correct for any material misstatements. [This answer is incorrect. When practitioners determine that the subject matter or the assertion in a review engagement is not modified to correct for any material misstatements, the attestation standards permit the practitioner to report as long as the problem is communicated in the report.]

    c. **When the practitioner determines that restrictions that significantly limit the scope of an examination engagement are imposed by the client. [This answer is correct. When the practitioner determines that restrictions that significantly limit the scope of an examination engagement are imposed by the client or the responsible party, the practitioner ordinarily should disclaim an opinion or withdraw from the engagement because the practitioner is unable to perform the procedures necessary to reach an opinion.]**

20. Which of the following is often a part of a larger consulting engagement involving information systems? **(Page 279)**

    a. **Reporting on part or all of an entity's internal control system. [This answer is correct. Reporting on part or all of an entity's internal control system is often a part of a larger consulting engagement involving information systems, accounting systems because information systems can be critical to internal control.]**

    b. Reporting on a financial projection or forecast. [This answer is incorrect. Reporting on a financial projection or forecast is often a part of a larger consulting engagement, such as a feasibility study or business acquisition study with the primary purpose being to provide advice to the client. Information systems would not be included because of the purpose.]

PERFORMANCE AND REPORTING ON APPLYING AGREED-UPON PROCEDURES ENGAGEMENTS

General

Authoritative Literature. AT 201, *Agreed-Upon Procedures Engagements*, provides guidance for performance and reporting in all agreed-upon procedures engagements. Additional guidance for agreed-upon procedures engagements related to forecasts and projections is found in AT 301, *Financial Forecasts and Projections*; additional guidance related to compliance with specified requirements is found in AT 601, *Compliance Attestation*.

A report on applying agreed-upon procedures may be presented along with a complete set of financial statements. When the practitioner consents to the inclusion of his or her agreed-upon procedures report in a document containing an entity's financial statements, he or she should follow the guidance in either SAS No. 26 (AU 504), *Association with Financial Statements* (applicable for audited financial statements of a nonpublic entity), or SSARS No. 1 (AR 100), *Compilation and Review of Financial Statements* (applicable for unaudited financial statements of a nonpublic entity), regarding his or her responsibility related to the financial statements.

In addition, the general, fieldwork, and reporting standards for attest engagements in AT 101 apply to agreed-upon procedures engagements. Exhibit 2-1 presents a list of engagements in which practitioners may apply specific procedures that are subject to authoritative literature other than the attestation standards in AT 201.

Exhibit 2-1

Engagements to Apply Specific Procedures That Are Not Subject to AT 201

Type of Engagement	Authoritative Literature
Engagements in which an auditor reports on specified compliance requirements based solely on an audit of financial statements	SAS No. 62 (AU 623), *Special Reports*
Engagements to report in accordance with *Government Auditing Standards*, the Single Audit Act, and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*[a]	SAS No. 74 (AU 801), *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*[b]
Engagements when service auditors are requested to apply certain substantive procedures to user transactions or assets at a service organization and to make reference in their report to having carried out those procedures[d]	SAS No. 70 (AU 324), *Service Organizations*[c]
Engagements to apply certain procedures to information contained in registration statements filed with the SEC	SAS No. 72 (AU 634), *Letters for Underwriters and Certain Other Requesting Parties*.
Engagements to provide consulting services	Statement on Standards for Consulting Services (CS 100)

Notes:

[a] A practitioner may agree, however, to apply agreed-upon procedures pursuant to the attestation standards. In that situation, the practitioner would apply the guidance in AT 201 and any applicable governmental requirements.

[b] Specific performance and reporting guidance is not included in the SAS but is included only in the applicable audit and accounting guides and Statements of Position. However, the Auditing Standards

Board has voted to issue a a final SAS, *Compliance Audits,* which supersedes SAS No. 74 (AU 801) for compliance audits for fiscal periods ending on or after June 15, 2010, with earlier application permitted. The SAS (a) clarifies applicability of the standard, (b) revises terminology and guidance for changes in the compliance audit environment, (c) establishes specific requirements for auditors to follow, and (d) identifies required elements of an auditor's report on compliance. As of the date of this course, the final standard has not been issues.

[c] The Auditing Standards Board has issued an exposure draft of a Statement on Standards for Attestation Engagements, *Reporting on Controls at a Service Organization,* that would replace the guidance currently in SAS No. 70 (AU 324) for auditors reporting on controls at service organizations (i.e., service auditors). Chapter 14 discusses the exposure draft.

[d] When service auditors are requested to apply certain agreed-upon procedures in an attest engagement, however, and to issue a separate report on such engagement, AT 201 does apply.

* * *

Definition of an Agreed-upon Procedures Engagement. An agreed-upon procedures engagement is one in which practitioners are engaged to report their findings based on specific procedures performed on subject matter. The engagement is performed to assist specified parties in evaluating subject matter, or an assertion about subject matter, based on their needs. The specified parties agree on the procedures to be performed by the practitioner, and take responsibility for the sufficiency of those procedures for their purposes. Because the needs of the specified parties may vary, the nature, timing, and extent of the agreed-upon procedures also may vary. In an engagement performed under AT 201, *Agreed-Upon Procedures Engagements*, the practitioner does not perform an examination or a review and does not provide an opinion or negative assurance. Rather, the practitioner's report is in the form of procedures and findings and should clearly indicate that its use is restricted to the specified parties who agreed on the procedures. The practitioner should not report on an agreed-upon procedures engagement when the specified parties do not agree on the procedures performed or to be performed or take responsibility for the sufficiency of those procedures for their purposes.

The Need for a Written Assertion. A written assertion generally is not required in an agreed-upon procedures engagement unless specifically required by another attestation standard, such as for compliance attestation. If, however, the practitioner requests a written assertion from the responsible party, the assertion can be presented in a representation letter or another form of written communication from the responsible party.

Subject Matter and Criteria. The subject matter for an agreed-upon procedures engagement may take many forms and may be as of a point in time or for a period of time. The agreed-upon procedures are applied to the subject matter using the criteria selected. Even though the procedures are agreed-upon by the specified parties, the subject matter and the criteria must satisfy the third general standard set forth in AT 101, *Attest Engagements*. (That is, the subject matter must be capable of evaluation against criteria that are both suitable and available to users.) The criteria used to measure the subject matter in an agreed-upon procedures engagement may be referred to in the practitioner's report or identified within the procedures listed in the procedures and findings section of the report.

Procedures to Be Performed. In an agreed-upon procedures engagement, responsibility for the nature, timing, and extent of procedures lies with the specified parties. Other than procedures that are overly subjective and open to varying interpretation, the accountant may generally perform and report on any procedures that are requested by the specified parties. Procedures may be as limited or extensive as the specified parties desire. The practitioner has no responsibility for making this determination. Terms of uncertain meaning (such as general review, limited review, reconcile, check, or test) should not be used to describe procedures unless they are defined. Examples of inappropriate procedures include:

- Mere reading of information.
- Evaluating the competency or objectivity of another party.

- Obtaining an understanding about a particular subject.

- Interpreting documents outside the scope of the practitioner's professional expertise.

The agreed-upon procedures should be performed entirely by the practitioner (the assistance of a specialist may be used). Practitioners can use schedules or other information provided by internal auditors when performing the agreed-upon procedures. However, it is not appropriate for practitioners to take responsibility for procedures performed by internal auditors and report those findings as their own or to imply in their report that responsibility for performing the agreed-upon procedures was shared with internal auditors.

Findings. The practitioner should present the results of applying agreed-upon procedures in the form of findings and avoid vague or ambiguous language in reporting those findings. Practitioners also should exercise extreme care in wording their findings to avoid representations not supported by their levels of work. A statement such as "We have ascertained (found or determined) that the net sales of ABC Company for the year 20X1 were $XX,XXX," could be considered such a representation. Practitioners are rarely in a position to use terms such as *correct*, *accurate*, and *verify* in a report because that language implies a level of precision that is inconsistent with the level of procedures applied.

Under AT 201, practitioners are prohibited from providing negative assurance. Instead, the practitioner expresses a positive finding for each procedure. For example, a statement such as "nothing came to our attention that caused us to believe that the [Identify subject matter.] is not presented based on [Identify criteria.] ," is not appropriate in an agreed-upon procedures report.

All findings from application of the agreed-upon procedures should be included in the practitioner's report. The concept of materiality does not apply to an agreed-upon procedures engagement unless materiality limits have been agreed upon by the specified parties. Any agreed-upon materiality limits should be described in the practitioner's report.

Representation Letter. A representation letter generally is not required in an agreed-upon procedures engagement. The need for a representation letter depends on the nature of the engagement and the specified parties. If the practitioner determines that it is necessary to obtain certain written representations from the responsible party, however, the responsible party's refusal to furnish those representations constitutes a limitation on the scope of the engagement. (Practitioners are required to obtain written representations from the responsible party in agreed-upon procedures engagements related to compliance with specified requirements and should follow the guidance provided later in this lesson if the responsible party refuses to provide those representations.)

Businessman's Reviews

Occasionally, auditors may be engaged to perform a special engagement known as an acquisition assistance engagement (often called a businessman's review or due diligence assistance). Such engagements generally are of a fact-finding nature and may involve a study of financial information and accounting practices, analysis of financial statements, review of working papers of other independent auditors, inspection of tax returns, and discussions with nonclient management and independent accountants. Depending on how the engagement is structured, it may contain aspects of both a consulting engagement and an agreed-upon procedures engagement. In many cases, however, these engagements cannot be characterized as true agreed-upon procedures engagements because the procedures are very general in nature and the practitioner's findings often consist of very subjective observations. In addition, the practitioner may or may not issue a written communication or report.

Reporting

A practitioner's report on applying agreed-upon procedures should be in the form of procedures and findings and should include the following elements:

a. A title that includes the word *independent*.

b. An identification of the specified parties.

c. Identification of the subject matter (or assertion related thereto) and the character of the engagement. (The reference to the character of the engagement would be to clarify the purpose of the procedures.)

d. Identification of the responsible party.

e. A statement that the subject matter is the responsibility of the responsible party.

f. A statement that the procedures performed were those agreed to by the specified parties.

g. A statement that the engagement was conducted in accordance with "attestation standards established by the American Institute of Certified Public Accountants."

h. A statement that the sufficiency of the procedures is solely the responsibility of the specified parties and a disclaimer of responsibility for the sufficiency of the procedures.

i. A list of the procedures performed (or a reference to such a listing) and related findings.

j. Where applicable, a description of any materiality limits agreed to by the specified parties.

k. A statement that the practitioner was not engaged to, and did not, conduct an examination of the subject matter, a disclaimer of opinion on the subject matter, and a statement that, if the practitioner had performed additional procedures, other matters might have come to his or her attention that would have been reported.

l. A statement restricting the use of the report to the specified parties.

m. Where applicable, any reservations or restrictions concerning procedures or findings.

n. Where applicable, a description of the nature of the assistance provided by a specialist.

o. For agreed-upon procedures on prospective financial information, the items included in AT 301.55.

p. The manual or printed signature of the practitioner's firm.

q. The date of the report.

Illustrative Report. The following is an illustration of an agreed-upon procedures report under AT 201.

INDEPENDENT ACCOUNTANT'S REPORT
ON APPLYING AGREED-UPON PROCEDURES

To ABC Company and XYZ Fund[a]

We have performed the procedures enumerated below, which were agreed to by ABC Company and XYZ Fund, solely to assist you in evaluating the accompanying Statement of Investment Performance Statistics of XYZ Fund (prepared in accordance with the criteria specified therein) for the year ended December 31, 20X1.[b] XYZ Fund's management is responsible for the Statement of Investment Performance Statistics. 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 those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

[Include paragraphs to enumerate procedures and findings.] [c]

We were not engaged to, and did not, conduct an examination, the objective of which would be the expression of an opinion on the accompanying Statement of Investment Performance Statistics of XYZ Fund. Accordingly, we do not express such an opinion.[d] 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 ABC Company and XYZ Fund and is not intended to be and should not be used by anyone other than these specified parties.[e]

Firm's Signature

City, State
February 15, 20X2[f]

Notes:

[a] The report ordinarily should be addressed to the client and to any other specified parties.

[b] In some agreed-upon procedures engagements, the practitioner may apply agreed-upon procedures to more than one subject matter or assertion. In those engagements, the practitioner may issue one report that refers to all subject matter covered or assertions presented.

[c] In describing the procedures performed, terms of uncertain meaning such as *general review*, *limited review*, *check*, or *test* should not be used without further explanation.

[d] If the subject matter consists of elements, accounts, or items of a financial statement, the first two sentences of this paragraph might read: "We were not engaged to, and did not, conduct an audit or a review, the objectives of which would be the expression of an opinion or limited assurance on the [Identify the elements, accounts, or items of a financial statement.] . Accordingly, we do not express such an opinion or limited assurance."

[e] The use of the practitioner's report on applying agreed-upon procedures is restricted to only those parties that have agreed on the procedures performed and taken responsibility for the sufficiency of those procedures.

[f] The report should be dated as of the date of completion of the agreed-upon procedures.

Report Modifications

Explanatory Language. The objective of an agreed-upon procedures engagement is to provide users with information concerning subject matter or an assertion about subject matter; thus, the report provides no opinion. Therefore, the practitioner does not weigh the findings or judge their significance. Instead, the report merely describes the procedures performed and discloses the practitioner's findings. However, if practitioners discover information that significantly contradicts the subject matter or assertion referred to in the practitioner's report by means other than the agreed-upon procedures, they should include that information in their report. For example, if the practitioners become aware of a material weakness in an entity's internal control during the audit of the entity's financial statements, that information should be included in the practitioner's report on agreed-upon procedures related to the entity's internal control.

The practitioner may have performed or been engaged to perform an audit of the entity's financial statements to which the subject matter of the agreed-upon procedures engagement relates. If the auditor's report on the financial statements includes one or more departures from the standard report, the practitioner should consider including a reference to the auditor's report and the departure from the standard report in his or her agreed-upon procedures report.

The practitioner's report on applying agreed-upon procedures may also include explanatory language about matters such as:

- Stipulated facts, assumptions, or interpretations used in applying the agreed-upon procedures.
- The condition of records, controls, or data to which the agreed-upon procedures were applied.
- That the practitioner has no responsibility to update his or her report.
- Sampling risk.

Scope Limitations. When circumstances impose restrictions on the scope of the engagement that the specified parties have not agreed to, the practitioners either should withdraw from the engagement or modify the report to describe the restriction. (When the restriction is client-imposed, best practices indicate the practitioners should withdraw.) Best practices also indicate that, if applicable, scope restrictions should be described in a separate paragraph following the procedures and findings section using language such as, "We were unable to [Describe scope restriction.] ."

If the practitioner determines that it is necessary to obtain written representations from the responsible party, the responsible party's refusal to furnish those representations constitutes a limitation on the scope of the engagement. In that case, the practitioner can either (a) disclose the inability to obtain the representations in his or her report, (b) withdraw from the engagement, or (c) change the engagement to another form of engagement, such as a consulting engagement. The first option, disclosing the inability to obtain the representations in his or her report, might be appropriate when, for example, the client has hired the practitioner to perform procedures on subject matter that is the responsibility of another party (that is, the client is not the responsible party). By including such a statement in the report, the client will be put on notice that the other party did not provide a representation letter. On the other hand, when the client is the responsible party, the practitioner should consider the potential risks of being associated with the engagement. Best practices indicate that a refusal to provide a representation letter calls into question the practitioner's ability to rely on any representations made by the responsible party. Consequently, in most cases, the practitioner should obtain the representation letter or withdraw from the engagement.

Adding Specified Parties

After completing the agreed-upon procedures engagement, the practitioner may agree to add another party as a specified party. In that case, the practitioner should obtain acknowledgement from the other party, preferably in writing, agreeing to the procedures performed and taking responsibility for the sufficiency of those procedures. If the practitioner has already issued his or her report, the report may be reissued with the new user included in the list of specified parties or the practitioner may provide a written acknowledgment that the new user has been added as a specified party. If the report is reissued, the date of the report should not be changed. If the practitioner provides a written acknowledgment, it should state that the practitioner has not performed any procedures subsequent to the date of his or her report.

Combined Reports Covering Both Restricted-use and General-use Subject Matter or Presentations

Practitioners may apply agreed-upon procedures as part of or in addition to other services such as an audit, compilation, or review of financial statements, another attest service, or a nonattest service. Agreed-upon procedures reports can be combined with reports on other types of services if the services can be clearly distinguished and the standards for each have been followed. If a practitioner issues a single combined report that covers both agreed-upon procedures and matters that are appropriate for general use, the use of the single combined report should be restricted. If a separate agreed-upon procedures report is included in a document that also includes a general-use report, the intended use of the reports is not affected. The agreed-upon procedures report remains restricted and the general-use report remains appropriate for general use.

REPORTING ON PROSPECTIVE FINANCIAL INFORMATION IN CONJUNCTION WITH AUDITED HISTORICAL FINANCIAL STATEMENTS

General

Authoritative Literature. Practitioners provide many services related to prospective (forward-looking) financial information. For example, they prepare income tax projections, analyze the possible effects of future changes in operations or the economic environment, help clients to develop budgets, assist individuals with personal financial planning, and assemble prospective financial statements to assist companies in obtaining financing. The prospective information may be presented alone or alongside, or in the same document as, audited historical financial statements. Also, auditors may or may not be asked to report on the prospective information. However, whether or not they are asked, in some circumstances auditors are required to report. Authoritative guidance for engagements involving prospective information specifying when and how to report is found in the AICPA's Statements on Standards for Attestation Engagements at AT 301, *Financial Forecasts and Projections*, and the companion *Guide for Prospective Financial Information* (the AICPA Guide).

This section briefly covers circumstances when auditors must report on prospective financial information presented alongside, or in the same document as, audited historical financial statements. Guidance below discusses compilation and agreed-upon procedures reports. This lesson does not discuss or illustrate examination reports because generally small business clients seldom will request examinations of *prospective* information.

Reporting Requirements—Auditor-Submitted Documents

AT 301 does not define "third-party"; however, most accountants agree that third parties would include:

a. stockholders (outside of management),

b. bankers,

c. government regulatory agencies, and

d. the general public, such as recipients of a tax shelter offering or prospectus related to a bond offering.

AT 301 states that, whenever practitioners (a) submit, to clients or others, prospective financial statements that they have assembled, or assisted in assembling, that are reasonably expected to be used by another (third) party or (b) report on prospective financial statements that are, or reasonably might be, expected to be used by another (third) party, the practitioners should compile, examine, or apply agreed-upon procedures to the statements as described below:

- *Examination*—the highest level of service that may be rendered with respect to prospective financial statements. The examination report provides positive assurance on the presentation and the reasonableness of the underlying assumptions.

- *Agreed-upon Procedures*—an engagement in which specified third-party users of the prospective financial statements participate in establishing the nature and scope of the engagement and take responsibility for the adequacy of the procedures to be performed.

  The agreed-upon procedures report presents factual findings. The scope of work performed may vary from low to high. This section discusses agreed-upon procedures reports for prospective information accompanying audited historical financial statements in an auditor-submitted document.

- *Compilation*—the lowest level of service permitted with respect to prospective financial statements that are intended for third-party use. A compilation report, as in a compilation of historical financial statements, does not express any assurance on the presentation or the underlying assumptions. This section discusses compilation reports for prospective information accompanying audited historical financial statements in an auditor-submitted document.

- *Special Rules for Budgets*—when interim historical financial statements are presented alongside current-period budgets (the budgeted statements may not extend beyond the current fiscal year end of the company), AT 301 allows for special reporting.

In addition to guidance on performing and reporting on those engagements, the AICPA Guide also provides guidance on services related to (a) partial presentations of prospective financial information and (b) prospective financial statements intended for internal use only.

Definitions of Forecast and Projection

A prospective financial statement may be either a forecast or a projection. AT 301.08 defines a forecast and a projection as follows:

> Forecast
>
> Prospective financial statements that present, to the best of the responsible party's [management's] knowledge and belief, an entity's expected financial position, results of operations, and cash flows. A financial forecast is based on the responsible party's assumptions reflecting conditions it expects to exist and the course of action it expects to take.
>
> Projection
>
> Prospective financial statements that present, to the best of the responsible party's [management's] knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations, and cash flows. A financial projection is sometimes prepared to present one or more hypothetical courses of action for evaluation, as in response to a question such as, "What would happen if . . .?" A financial projection is based on the responsible party's assumptions reflecting conditions it expects would exist and the course of action it expects would be taken, given one or more hypothetical assumptions.
>
> The term *hypothetical assumption* is defined as "an assumption used in a financial projection to present a condition or course of action that is not necessarily expected to occur, but is consistent with the purpose of the projection."

A projection has only *limited use*. That is, it is only appropriate for use by the responsible party or third parties with whom the responsible party is negotiating directly. There is no such restriction on the use of a forecast. Forecasts and projections may be expressed as a single point estimate or as a range of expected results.

Title of a Financial Forecast or Projection

The title of a financial forecast should describe the nature of the presentation and should contain the word "forecast" or "forecasted," e.g., "forecasted balance sheet." The title of a financial projection should not imply that the presentation is a forecast, e.g., it would ordinarily contain the word "projection" or "projected." Also, the title of a projection should refer to the significant hypothetical assumption on which it is based, e.g., "Projected Results of Operations If a New Plant Is Constructed." In identifying the forecasted or projected period being presented, the phrase "Year Ending December 31, 20X2," is used instead of the phrase used for historical financial statements, "Year End*ed*..." The word "End*ed*" connotes an expired period, while the word "End*ing*" has a prospective connotation. When prospective and historical statements are presented together in parallel columns, the title should appropriately describe each type of statement, and the columns should be clearly labeled as illustrated below.

> ABC CORPORATION
> BALANCE SHEETS
> December 31, 20X1 (Historical) and 20X2 (Forecasted)

or

ABC CORPORATION
STATEMENTS OF INCOME AND RETAINED EARNINGS
Year Ended December 31, 20X1 (Historical) and
Year Ending December 31, 20X2 (Forecasted)

Standard Compilation Report

As prescribed by AT 301, the practitioner's standard report on a compilation of a financial forecast or projection should contain the following elements:

a. An identification of the prospective financial statements presented by the responsible party.

b. A statement that the practitioner compiled the prospective financial statements in accordance with attestation standards established by the AICPA.

c. A statement that a compilation is limited in scope and does not enable the practitioner to express an opinion or any other form of assurance on the prospective financial statements or the assumptions.

d. A caveat that the prospective results may not be achieved.

e. A statement that the practitioner assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

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

g. The manual or printed signature of the accountants' firm.

h. If the presentation is a projection, a separate paragraph that describes the limitations on the usefulness of the presentation.

i. If the presentation contains a range, a separate paragraph that states that the responsible party has portrayed certain assumptions in terms of a range.

j. If the accountants are not independent, a statement that they are not.

k. A description of any deficiencies in the presentation (other than those relating to the assumptions).

l. In addition to those elements, the accountants' report for a projection also should include the following:

- A statement describing the special purpose for which the projection was prepared.

- A separate paragraph that restricts the use of the presentation because it is intended to be used solely by the specified parties.

The report on the compiled forecast or projection may be presented as a separate report or combined with the auditor's report on the historical financial statements. Best practices indicate that when the forecast or projection is presented on separate pages from the historical statements, it is preferable to present a separate report. When the prospective information is presented in columns alongside the historical statements, a combined report is appropriate.

Modifications of the Standard Compilation Report

AT 301 allows practitioners to compile a financial forecast or projection that has presentation deficiencies or that omits disclosures *other than those relating to significant assumptions*, provided that the deficiency or omission is not, to their knowledge, undertaken with the intention of being misleading. AT 301 requires practitioners to disclose the deficiency or omission in their report. The following observations are made about that provision:

- Practitioners may not be associated with any prospective presentation intended for third-party use that does not disclose the significant assumptions on which the presentation is based (except for a special provision related to budgets). The AICPA Guide refers to presentation guidelines that include specific requirements for the types of assumptions that should be disclosed and for an introduction that must accompany the assumptions in a compiled presentation. The guidelines also require that each page of the prospective presentation include a reference directing attention to the summary of significant assumptions.

- As in a SSARS compilation, a stand-alone compiled prospective presentation may omit disclosure of significant accounting policies. That situation normally would not arise in a compiled forecast or projection accompanying audited historical financial statements, because the audited statements must disclose the accounting policies if an unqualified audit opinion is expressed. The prospective presentation could simply include a cross-reference to the disclosure in the historical statements. (Each page of the prospective presentation includes a reference to the summary of accounting policies if one is presented.)

Agreed-upon Procedures Report

Agreed-upon procedures may be applied to prospective financial statements generally when management or a user, such as a bank, wants less assurance than that provided by an examination but wants the practitioner to apply more procedures than in a compilation. The practitioner should not report on an agreed-upon procedures engagement unless the specified parties agree on the procedures performed or to be performed and take responsibility for the sufficiency of the procedures for their purposes. The broad standards for applying agreed-upon procedures to prospective financial statements are the same as those required in AT 101, *Attest Engagements*, and AT 201, *Agreed-Upon Procedures Engagements*. The following paragraphs discuss reporting guidance unique to prospective financial statement engagements, as provided by AT 301, *Financial Forecasts and Projections*.

AT 301 requires that the report on the results of applying agreed-upon procedures to prospective financial statements include the following elements:

a. A title that includes the word *independent*.

b. An identification of the specified parties.

c. A reference to the prospective financial statements covered by the report and the character of the engagement. (The reference to the character of the engagement would be to clarify the purpose of the procedures.)

d. A statement that the procedures performed were those agreed to by the specified parties identified in the report.

e. Identification of the responsible party and a statement that the prospective financial statements are the responsibility of the responsible party.

f. A statement that the agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants.

g. A statement that the sufficiency of the procedures is solely the responsibility of the specified parties and a disclaimer of responsibility for the sufficiency of the procedures.

h. A list of the procedures performed (or a reference to such a listing) and related findings.

i. Where applicable, a description of any materiality limits agreed to by the specified parties.

j. A statement that the practitioner was not engaged to, and did not, conduct an examination of the prospective financial statements.

k. A disclaimer of opinion about whether the presentation is in conformity with AICPA presentation guidelines.

l. A disclaimer of opinion about whether the underlying assumptions provide a reasonable basis for the forecast, or a reasonable basis for the projection given the hypothetical assumptions.

m. A statement that if additional procedures had been performed, other matters might have come to the practitioner's attention that would have been reported.

n. A statement restricting the use of the report because it is intended to be used solely by the specified parties.

o. Where applicable, any reservations or restrictions concerning procedures or findings.

p. A caveat that the prospective results may not be achieved.

q. A statement that the practitioner assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

r. Where applicable, a description of the nature of the assistance provided by a specialist.

s. The manual or printed signature of the practitioner's firm.

t. The date of the report.

If the presentation contains a range, generally the report should also include both a separate paragraph that states that the responsible party has elected to portray the results of one or more assumptions as a range and a warning that the actual results may not fall within the range presented.

AT 301 and the AICPA *Guide* prohibit the use of any type of negative assurance. Instead, the practitioner would express a positive finding for each procedure.

Expired Budget

Historical financial statements may be presented alongside, or in the same document with, an expired budget, i.e., a budget covering the same period as the historical statements. An *expired* budget is not a prospective presentation but should be treated as historical, supplementary information.

Budgets Accompanying Interim Historical Financial Statements

AT 301 contains special provisions for budgets accompanying interim historical financial statements in a practitioner-submitted document. The special provisions apply if the following conditions exist:

a. The prospective financial statements are labeled as a "budget."

b. The budget does not extend beyond the end of the current fiscal year.

c. The budget is presented with *interim* historical financial statements for the current year (emphasis added).

An illustration may help explain the preceding guidance. Assume that the auditors have audited interim historical financial statements and assisted in preparing a budget for a company's fiscal year ending December 31, 20X2. The following columnar presentation would fall under the special provisions:

Actual results Six months ended June 30, 20X2	Budget Six months ended June 30, 20X2	Budget 12 months ending December 31, 20X2

Note that the second column is an expired budget and thus would be treated as supplementary information to the June 30, 20X2, historical financial statements (the actual column). However, the third column is prospective because it contains six future months. Since the budget in the third column does not extend beyond the fiscal year end, the special provisions in AT 301 apply. If this presentation contained another column, say, for a budget for the six months ending on June 30, 20X3, the special provisions would no longer apply.

If the preceding conditions are met, practitioners are not required to apply compilation, agreed-upon, or examination procedures to the budget even though the presentation is expected to be used by third parties. Also, practitioners are not required to disclose significant assumptions or accounting policies relating to the budget, providing such omissions are not, to their knowledge, undertaken with the intention of misleading those who might use the information.

Practitioners should issue the following disclaimer on the budget:

> The accompanying budgeted[a] balance sheet, statements of income, retained earnings, and cash flows of ABC Company as of December 31, 20X2, and for the year then ending,[b] have not been compiled or examined by us, and, accordingly, we do not express an opinion or any other form of assurance on them.[c]
>
> Management has elected to omit the summary(ies) of significant assumptions (and accounting policies) required under established guidelines for presentation of prospective financial statements. If the omitted summary(ies) were included in the budgeted information, it (they) might influence the user's conclusions about the Company's budgeted information. Accordingly, this budgeted information is not designed for those who are not informed about such matters.[d]
>
> **Notes:**
>
> [a] The report refers to the accompanying *budget*. The prospective presentation must be called a budget for this report to be appropriate.
>
> [b] The report refers to the period covered by the budget. This period must not extend beyond the end of the current fiscal year or else this report may not be used.
>
> [c] The report states that the budget was not compiled or examined, and it disclaims any assurance.
>
> [d] If the summary of significant assumptions or accounting policies is omitted, a paragraph must be added to the report to call attention to the omission. The accounting policies are not likely to be omitted, because the accounting policies relating to historical financial statements, which must be presented, typically will also apply to the budget.

Prospective Information in Client-prepared Documents

So far, this section has assumed that prospective financial information is included in an auditor-submitted document containing audited historical financial statements. This section has summarized the requirement of AT 301 that the prospective information be examined, compiled, or subjected to agreed-upon procedures in such circumstances, and reported on accordingly. AT 301 also addresses the auditor's reporting responsibility when a prospective presentation is presented in a client-prepared document containing audited financial statements. AT 301 allows auditors the following options if they consent to the use of their name in the document:

a. Examine, compile, or apply agreed-upon procedures to the prospective presentation and report accordingly.

b. Make sure the prospective presentation includes an indication by the responsible party or the practitioners that the practitioners have not performed any of the services mentioned in item (a) and assume no responsibility for it.

c. If other practitioners have reported on the prospective presentation, make sure their report is included in the document.

Also, AT 301 states that, in certain circumstances described in it, the auditors should refer to SAS No. 8 (AU 550), *Other Information in Documents Containing Audited Financial Statements*.

PRO FORMA FINANCIAL INFORMATION REPORTING

Definition

Pro forma financial presentations commonly are defined as financial presentations that are designed to demonstrate the effect of a future or hypothetical transaction by showing how it might have affected the historical financial statements if it had been consummated during the period covered by those financial statements. Although such future or hypothetical transactions are prospective in nature, pro forma financial presentations essentially are historical financial statements and do not purport to be prospective financial statements. Accordingly, AT 301, *Financial Forecasts and Projections*, and the AICPA *Guide for Prospective Financial Information*, do not apply to pro forma financial presentations.

Reporting Guidance

Most requests to report on pro forma financial information relate to filings with the Securities and Exchange Commission, and requests from nonpublic companies are less frequent. Occasionally, however, nonpublic companies present pro forma financial presentations (a) in the notes to audited financial statements or (b) as additional information in an auditor-submitted document. Such information frequently is used to show the effects of the following events:

a. Business combinations.

b. Changes in capitalization.

c. Dispositions of a significant part of a business.

d. Changes in the form of business organization or status as an autonomous entity.

e. Other subsequent events.

Pro forma financial information presented on the face of, or in the notes to, audited financial statements should be marked as "unaudited" or "not covered by auditor's report," and need not be referred to in the auditor's report. Generally, when pro forma information is presented as additional information in an auditor-submitted document, auditors normally should disclaim an opinion on the information.

AT 401, *Reporting on Pro Forma Financial Information*, provides performance and reporting guidance to practitioners who have been engaged to issue or do issue an examination or review report on pro forma information. In other words, there is no *requirement* to report on it. AT 401 allows the practitioners to examine or review pro forma information under the following conditions:

a. The document containing the pro forma information includes or incorporates by reference the company's (or the most significant part of a combined company's) historical financial statements for the most recent year or for the preceding year if those statements are not yet available. If the pro forma information is presented for an interim period, the historical interim financial information for that period also should be presented or incorporated by reference.

b. The historical financial statements of the company have been audited or reviewed and the audit or review report is included in the document containing the pro forma information. The level of assurance given by the practitioners on the pro forma information is limited to the level of assurance given on the historical financial statements.

c. The practitioners have an appropriate level of knowledge of the company's accounting and financial reporting practices.

AT 401 requires practitioners to comply with the general and fieldwork standards for attest engagements (AT 101), as well as the specific performance and reporting standards set forth in AT 401.

AT 401 applies to both public and nonpublic companies. However, generally few nonpublic companies will need examinations or reviews of their pro forma information. It is important, however, for practitioners to be familiar with the requirements of AT 401, because many of those requirements may easily be applied to other types of services on pro forma information.

SSARS No. 14, *Compilation of Pro Forma Financial Information*, expands the scope of compilation standards and allows accountants to compile pro forma financial information. The statement also establishes performance and reporting standards for these engagements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Engagements to apply certain procedures to information in registration statements filed with the Securities and Exchange Commission are subject to which of the following authoritative literature other than the attestation standards in AT 201?

    a. SAS No. 62 (AU 623).

    b. SAS No. 70 (AU 324).

    c. SAS No. 72 (AU 634).

    d. SAS No. 74 (AU 801).

22. Which of the following statements is accurate regarding procedures to be performed in an agreed-upon procedures engagement?

    a. An appropriate procedure would be evaluating the competency of another party.

    b. The practitioner may perform and report on all procedures that are requested by the specified parties.

    c. The practitioner is not responsible for deciding how extensive the procedures to be performed will be.

    d. Terms such as *general review* or *limited review* should be routinely used to describe procedures performed.

23. An acquisition assistance engagement generally is likely to contain more aspects of which of the following types of engagements?

    a. Consulting engagement.

    b. Agreed-upon procedures engagement.

24. If the practitioner needs to obtain written representations that the responsible party refuses to provide, a limitation on the scope of the engagement results. Which of the following actions might be most appropriate if the client has hired the practitioner to perform procedures on subject matter where the client is not the responsible party?

    a. Disclose the inability to obtain the representations in the report.

    b. Obtain the representation letter or withdraw from the engagement.

25. Which of the following is the lowest level of service that is permitted for prospective financial statements that are intended for third-party use?

    a. Compilation.

    b. Agreed-upon procedures.

    c. Examination.

26. Nonpublic companies sometimes present pro forma financial presentations as additional information in an auditor-submitted document. This additional information many times is used to show the effects of all the following events **except**:

    a. Capitalization changes.

    b. Dispositions of any portion of a business.

    c. Business combinations.

    d. Changes in the form of business organization.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. Engagements to apply certain procedures to information in registration statements filed with the Securities and Exchange Commission are subject to which of the following authoritative literature other than the attestation standards in AT 201? **(Page 284)**

    a. SAS No. 62 (AU 623). [This answer is incorrect. Engagements in which an auditor reports on specified compliance requirements based entirely on an audit of financial statements are subject to SAS No. 62 (AU 623).]

    b. SAS No. 70 (AU 324). [This answer is incorrect. Engagements when service auditors are requested to apply certain substantive procedures to user transactions or assets at a service organization and to make reference in their report to having carried out those procedures are subject to SAS No. 70 (AU 324).]

    c. SAS No. 72 (AU 634). [This answer is correct. Engagements to apply certain procedures to information contained in registration statements filed with the SEC are subject to SAS No. 72 (AU 634), *Letters for Underwriters and Certain Other Requesting Parties*.]

    d. SAS No. 74 (AU 801). [This answer is incorrect. Engagements to report in accordance with *Government Auditing Standards*, the Single Audit Act, and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, are subject to SAS No. 74 (AU 801).]

22. Which of the following statements is accurate regarding procedures to be performed in an agreed-upon procedures engagement? **(Page 285)**

    a. An appropriate procedure would be evaluating the competency of another party. [This answer is incorrect. This would be inappropriate because this would be overly subjective. Another inappropriate procedure would be mere reading of information.]

    b. The practitioner may perform and report on all procedures that are requested by the specified parties. [This answer is incorrect. The practitioner may generally perform and report on any procedures requested by the specified parties except for procedures that are overly subjective and subject to differing interpretation.]

    c. The practitioner is not responsible for deciding how extensive the procedures to be performed will be. [This answer is correct. Responsibility for determining how extensive or limited the procedures to be performed will be is the responsibility of the specified parties, not the practitioner.]

    d. Terms such as *general review* or *limited review* should be routinely used to describe procedures performed. [This answer is incorrect. Terms such as general review or limited review have uncertain meanings and should be avoided unless their definition is provided.]

23. An acquisition assistance engagement generally is likely to contain more aspects of which of the following types of engagements? **(Page 286)**

    a. Consulting engagement. [This answer is correct. Acquisition assistance engagements are characterized by procedures that are very general in nature and practitioner's findings many times consist of subjective observations. As such, acquisition assistance engagements generally are likely to contain more aspects of consulting engagements than agreed-upon procedures engagements.]

    b. Agreed-upon procedures engagement. [This answer is incorrect. Agreed-upon procedures engagements require issuance of a written communication or report that may not be necessary in the case of an acquisition assistance engagement due to its fact-finding nature.]

24. If the practitioner needs to obtain written representations that the responsible party refuses to provide, a limitation on the scope of the engagement results. Which of the following actions might be most appropriate if the client has hired the practitioner to perform procedures on subject matter where the client is not the responsible party? **(Page 289)**

    a. **Disclose the inability to obtain the representations in the report. [This answer is correct. Disclosing the lack of representations in the report lets the client know that the other party (responsible party) did not provide a representation letter. This may be the most appropriate action to take.]**

    b. Obtain the representation letter or withdraw from the engagement. [This answer is incorrect. When the client is the responsible party and refuses to provide written representations, the practitioner should assess the potential risks of being associated with the engagement. Refusal by the client to provide a representation letter jeopardizes the practitioner's ability to rely on any representations made by the client. As a result, generally the practitioner should obtain the representation letter or withdraw from the engagement.]

25. Which of the following is the lowest level of service that is permitted for prospective financial statements that are intended for third-party use? **(Page 290)**

    a. **Compilation. [This answer is correct. The compilation report is the lowest level of service permitted regarding prospective financial statements that are intended for third-party use, and the report does not express any assurance on the presentation or the underlying assumptions.]**

    b. Agreed-upon procedures. [This answer is incorrect. The agreed-upon procedures report presents factual findings and the scope of work performed may vary from high to low.]

    c. Examination. [This answer is incorrect. The examination report is the highest level of service that may be provided for prospective financial statements and provides positive assurance on the presentation and the reasonableness of the underlying assumptions.]

26. Nonpublic companies sometimes present pro forma financial presentations as additional information in an auditor-submitted document. This additional information many times is used to show the effects of all the following events **except**: **(Page 296)**

    a. Capitalization changes. [This answer is incorrect. Showing the effects capitalization changes might have affected the historical financial statements if it had been consummated during the period covered by the statements is one way nonpublic companies use pro forma financial presentations as additional information in auditor-submitted documents. Other subsequent events might also be presented in pro forma statements.]

    b. **Dispositions of any portion of a business. [This answer is correct. The pro forma financial presentations presented by nonpublic companies as additional information in auditor-submitted documents is sometimes used to show the effects of dispositions of a *significant* part of a business, but not just any portion of a business.]**

    c. Business combinations. [This answer is incorrect. Nonpublic companies may present pro forma financial presentations as additional information in auditor-submitted documents to show the effects that business combinations could have had on the historical financial statements had it happened during the period covered. This information can be presented in the notes to audited financial statements or as additional information in an auditor-submitted document.]

    d. Changes in the form of business organization. [This answer is incorrect. Nonpublic companies will sometimes present pro forma financial presentations as additional information in auditor-submitted documents to demonstrate the effects of changes in the form of business organization would have had on the historical statements should the change occurred during the covered period.]

COMPLIANCE WITH REQUIREMENTS OF LAWS, REGULATIONS, OR RULES REPORTING

General

Authoritative Literature. AT 601, *Compliance Attestation*, provides guidance for engagements related to (a) compliance with requirements of specified laws, regulations, rules, contracts, or grants (compliance with specified requirements) and (b) the effectiveness of the entity's internal control over compliance with such specified requirements (internal control over compliance). Exhibit 2-2 presents examples of services not covered by AT 601 that deal with the same subject matter as those described in this section and the professional standards that provide guidance on them. Attest engagements conducted in accordance with AT 601 should also comply with the general, fieldwork, and reporting standards in AT 101.

What Are Compliance Attestation Services? Compliance attestation services are engagements designed to consider whether an entity complies with the requirements of specified laws, regulations, rules, contracts, or grants. The practitioner may be asked to report on (a) the entity's actual compliance with those requirements as of a point in time or over a period of time, (b) the effectiveness of the controls the entity implements to ensure continuous compliance with those requirements, or (c) both. The practitioner may be engaged to perform an examination or agreed-upon procedures to assist users in evaluating subject matter (that is, compliance or the effectiveness of internal control) or assertions about the subject matter. The practitioner should not accept an engagement to perform a review under AT 601. Whenever practitioners are asked to provide advice about the type of service to be provided, they generally should suggest an agreed-upon procedures engagement under AT 601 rather than an examination engagement. The practitioners' risk of litigation generally is lower in agreed-upon procedures engagements than in examinations.

Exhibit 2-2

Similar Engagements Not Subject to AT 601 and the Applicable Literature

Type of Engagement	Applicable Literature
Reports on compliance with contractual provisions in connection with a financial statement audit.	SAS No. 62 (AU 623)
Compliance with laws and regulations in audits conducted in accordance with *Government Auditing Standards* (Yellow Book), the Single Audit Act, or OMB Circular A-133.	SAS No. 74[a] (AU 801)
Letters to underwriters.	SAS No. 72 (AU 634)
Advice on improvements in compliance or internal control over compliance with specified requirements.	SSCS No. 1 (CS 100)

Note:

[a] The Auditing Standards Board has voted to issue a final SAS, *Compliance Audits,* which supersedes SAS No. 74 (AU 801) for compliance audits for fiscal periods ending on or after June 15, 2010, with earlier application permitted. The SAS (a) clarifies applicability of the standard, (b) revises terminology and guidance for changes in the compliance audit environment, (c) establishes specific requirements for auditors to follow, and (d) identifies required elements of an auditor's report on compliance. As of the date of this course the final standard had not been issued.

* * *

The most common requests for a compliance attestation service involve compliance with:

- Contractual requirements of debt agreements.
- Bookkeeping or accounting requirements of partnership agreements.
- Requirements of agency agreements (for example, the Department of Education lender audits).
- Laws or regulations, such as the EPA guidelines for oxygen content in gasoline.

Although compliance attestation services often involve issues relating to compliance with laws or regulations, the practitioners' report is not a legal opinion. Rather, it is the result of a professional accounting service in which the practitioners exercise their (limited) understanding of the law and, when necessary, legal interpretations made by attorneys or others with an understanding of the requirements in question.

Form of Written Assertion. As part of an engagement under AT 601, the practitioner should obtain a written assertion about the entity's compliance with specified requirements or internal control over compliance from the responsible party (that is, the party responsible for the compliance). Generally, the entity's management is the responsible party. The responsible party may present such a written assertion in either of the following forms:

- A separate report that will accompany the practitioner's report.
- A representation letter to the practitioner.

If the responsible party does not provide a written assertion as discussed in the preceding paragraph in an examination engagement, the practitioners should withdraw from the engagement, unless an examination of compliance with specified requirements is required by law or regulation. In that case, practitioners should disclaim an opinion on compliance unless evidence gathered by them warrants an adverse opinion. When practitioners issue an adverse opinion and a written assertion has not been obtained, AT 601.13 requires practitioners to restrict the use of their report. It is silent, however, with respect to the need to restrict a practitioners' report that contains a disclaimer of opinion. But the fourth standard of reporting requires practitioners to restrict their report when *reporting on subject matter and a written assertion has not been received from the responsible party*. Therefore, to be consistent with the fourth standard, practitioners generally should also restrict the use of reports containing a disclaimer of opinion when a written assertion is not received.

If the responsible party is the client and does not provide a written assertion in an agreed-upon procedures engagement, practitioners should not report on the engagement (that is, they should withdraw) unless the engagement is required by law or regulation. If the practitioner's client is not the responsible party, withdrawal is not required, but practitioners should consider the effects of the responsible party's refusal on the engagement and the practitioners' report.

Best practices indicate that, if the responsible party does not provide a written assertion, the practitioners should consider structuring the engagement as a consulting engagement. Such an engagement should conform to the requirements of SSCS No. 1 (CS 100). Alternatively, when the practitioners have audited the entity's financial statements, it may be more practical to provide negative assurance on compliance with contractual or regulatory provisions.

Criteria. Criteria are the standards or benchmarks against which practitioners evaluate compliance. Criteria used to evaluate compliance must be *suitable* and *available* to all users. Some criteria may be appropriate in evaluating compliance for only a limited number of parties who either participated in establishing the criteria or who can be presumed to have an adequate understanding of the criteria. When criteria are appropriate only for a limited number of parties, the use of the practitioner's report should be restricted to those specified parties who either participated in establishing the criteria or who can be presumed to have an adequate understanding of the criteria. In addition, if the criteria are only available to specified parties, the practitioner's report should be restricted to those parties who have access to the criteria. The use of reports on agreed-upon procedures engagements should always be restricted.

The criteria used for reports on compliance with specified requirements are usually clear-cut. They ordinarily are spelled out in the requirements themselves. Sometimes, however, the requirements are not as explicit. If the criteria are not included in the specified requirements, the practitioner's examination report should identify the criteria. If significant interpretations are required, practitioners can disclose those interpretations in their examination or agreed-upon procedures reports.

A practitioner may be engaged to examine the effectiveness of an entity's internal control over compliance. The suitability of criteria for reports on internal control over compliance may be difficult to determine. Although criteria such as the Committee of Sponsoring Organizations (COSO) of the Treadway Commission's Report, *Internal Control—Integrated Framework*, provides suitable criteria against which to evaluate the effectiveness of an entity's internal control, more detailed criteria relative to specific compliance requirements may have to be developed to apply the COSO report to internal control over compliance. The suitability of criteria used to examine the effectiveness of internal control over compliance should be determined by reference to the general guidance provided in AT 101. If a practitioner determines that appropriate criteria exist for internal control over compliance, the examination engagement should be performed in accordance with AT 101. In addition, AT 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated Within an Audit of Its Financial Statements*, may be helpful to a practitioner in such an engagement.

Representation Letter. In an examination or agreed-upon procedures engagement, the practitioner should obtain a representation letter from the responsible party that includes the matters outlined in AT 601. (When the client is not the responsible party, the practitioner also may want to obtain written representations from the client.) Refusal to furnish representations in an examination engagement is a scope limitation sufficient to preclude an unqualified opinion. Such a refusal ordinarily causes the practitioner to disclaim an opinion or withdraw from an examination engagement, unless he or she concludes a qualified opinion is appropriate because of the nature of the representations not obtained or the circumstances surrounding the refusal. In an agreed-upon procedures engagement, when the client is the responsible party, refusal to furnish representations is a scope limitation sufficient to cause the practitioner to withdraw from the engagement. When the client is not the responsible party, the practitioner is not required to withdraw, but should consider the effects of the refusal on his or her report. The practitioner also should consider the effects of the refusal on his or her ability to rely on other representations.

Agreed-upon Procedures Engagement

Overview of the Engagement. The objective of an agreed-upon procedures engagement is to apply procedures specified by the intended users of the report to assist users in evaluating an entity's compliance with specified requirements or internal control over compliance and communicate the resulting findings. The practitioner should not report on an agreed-upon procedures engagement unless the specified users agree on the procedures and take responsibility for the sufficiency of those procedures for their purposes. According to AT 601, a practitioner engaged to perform agreed-upon procedures related to compliance with specified requirements or internal control over compliance should also follow the guidance set forth in AT 201.

Reporting Requirements. The practitioners' report should include a description of procedures performed and findings made. It should not provide negative assurance about compliance. The practitioner's report should include the following elements:

a. A title that includes the word *independent*.

b. Identification of the specified parties.

c. Identification of the subject matter (or assertion), including the period or point in time, and a reference to the character of the engagement. (The reference to the character of the engagement would be to clarify the purpose of the procedures.)

d. Identification of the responsible party.

e. A statement that the subject matter is the responsibility of the responsible party.

f. A statement that the procedures, which were agreed to by the specified parties, were performed to assist the specified parties in evaluating the entity's compliance with specified requirements or the effectiveness of its internal control over compliance.

g. A statement that the engagement was conducted in accordance with "attestation standards established by the American Institute of Certified Public Accountants."

h. A statement that the sufficiency of the procedures is solely the responsibility of the specified parties and a disclaimer of responsibility for the sufficiency of those procedures.

i. A listing of procedures performed (or a reference to a schedule where those procedures are detailed) and related findings.

j. Where applicable, a description of any agreed-upon materiality limits.

k. A statement that the practitioner was not engaged to, and did not, conduct an examination of the entity's compliance with specified requirements or the effectiveness of the entity's internal control over compliance, and a disclaimer of opinion thereon. The report should include a statement that, if the practitioner had performed additional procedures, other matters might have come to the practitioner's attention that would have been communicated in the practitioner's report.

l. A statement restricting the use of the report to the specified parties.

m. Where applicable, reservations or restrictions about the procedures or findings.

n. Where applicable, a description of the nature of assistance provided by a specialist.

o. The manual or printed signature of the practitioner's firm.

p. The date of the report.

Agreed-upon Procedures Report on Compliance with Specified Requirements. Presented below is an illustration of a report on the results of applying agreed-upon procedures related to an entity's compliance with specified requirements.

INDEPENDENT ACCOUNTANT'S REPORT
ON APPLYING AGREED-UPON PROCEDURES

To ABC Company and XYZ Bank[a]

We have performed the procedures enumerated below, which were agreed to by ABC Company and XYZ Bank,[b] solely to assist the specified parties in evaluating ABC Company's compliance with Items f.–h. in the Loan Indenture during the period January 1 through December 31, 20X1. Management is responsible for the ABC Company's compliance with those requirements. 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 those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

[Include paragraphs to enumerate procedures and findings.] [c, d]

We were not engaged to, and did not conduct an examination, the objective of which would be the expression of an opinion on compliance. 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 ABC Company and XYZ Bank and is not intended to be and should not be used by anyone other than these specified parties.

Firm's Signature

City, State
February 15, 20X2[e]

Notes:

[a] The report ordinarily should be addressed to the entity and to the specified parties.

[b] The report should identify the specified parties (that is, the specified users of the report).

[c] When evaluating compliance with specified requirements, practitioners might have to rely on interpretations of the laws, regulations, rules, contracts, or grants establishing those requirements. When the interpretations are considered significant, practitioners should consider including a paragraph stating the description and source of the interpretations made by the entity's management. An example of such a paragraph, which should precede the procedures and findings paragraph, follows:

> We have been informed that, under ABC Company's interpretation of Item f., working capital as of December 31, 20X1, includes goodwill and patent rights.

[d] The report should include a listing of procedures performed (or a reference to a schedule where those procedures are detailed) and related findings. The description of the procedures applied should be specific enough to allow the reader to understand the nature and extent of the procedures. Terms that are vague, such as *general* or *limited review*, *reconcile*, *check*, or *test*, should not be used unless the procedures are described in more detail. If the procedures are very extensive or detailed, the practitioners may choose to refer to a description of them rather than detailing them in the report. For example, the procedures and their results may be described in an addendum to the report. In that case, the first sentence of the report might begin:

> We have performed the procedures enumerated in Appendix A to this report, which were agreed to by . . .

The second paragraph of the report might read:

> The procedures we applied and our findings are described in Appendix A to this report.

If a third party user, such as a regulatory agency, publishes documents listing the agreed-upon procedures, the first sentence of the report might read as follows:

> We have performed the procedures included in [title of publication or other document] and enumerated below, which were agreed to by ABC Company and XYZ Bank, solely to assist the specified parties in evaluating . . .

[e] The report should be dated as of the date of completion of the agreed-upon procedures.

Agreed-upon Procedures Report on the Effectiveness of Internal Control over Compliance. Presented below is an illustration of a report on the results of applying agreed-upon procedures related to the effectiveness of an entity's internal control over compliance with specified requirements.

INDEPENDENT ACCOUNTANT'S REPORT
ON APPLYING AGREED-UPON PROCEDURES

To ABC Company and XYZ Bank

> We have performed the procedures enumerated below, which were agreed to by ABC Company and XYZ Bank, solely to assist the specified parties in evaluating the effectiveness of ABC Company's internal control over compliance with Items f.–h. in the Loan Indenture as of December 31, 20X1. Management is responsible for ABC Company's internal control over compliance with those requirements. 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 those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.
>
> <u>[Include paragraphs to enumerate procedures and findings.]</u>
>
> We were not engaged to, and did not, conduct an examination, the objective of which would be the expression of an opinion on the effectiveness of internal control over compliance. 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 ABC Company and XYZ Bank and is not intended to be and should not be used by anyone other than these specified parties.

Agreed-upon Procedures Report on Both Compliance and Internal Control over Compliance. If the engagement covers both compliance with specified requirements and the effectiveness of internal control over compliance, the practitioners may address both in one report. In that case, the first sentence of the report might read as follows:

> We have performed the procedures enumerated below, which were agreed to by ABC Company and XYZ Bank, solely to assist the specified parties in evaluating ABC Company's compliance with Items f.–h. in the Loan Indenture during the period January 1, 20X1 through December 31, 20X1, and the effectiveness of ABC Company's internal control over compliance with the aforementioned compliance requirements as of December 31, 20X1.

Report Modifications. The objective of an agreed-upon procedures engagement is to provide users with information concerning compliance with specified requirements or the effectiveness of internal control over compliance; thus, the report provides no opinion. Therefore, the practitioner does not weigh the instances of noncompliance or judge their significance. Instead, the report merely describes the results of procedures performed and discloses any noncompliance (or ineffective controls over compliance, if applicable) that comes to the practitioner's attention.

<u>Material Noncompliance.</u> If the practitioners discover noncompliance or ineffective controls by means other than the agreed-upon procedures, they should include such information in their report. For example, if the practitioners discover information during the audit of the entity's financial statements or from reading regulator's reports, a sentence such as the following should be added to the report after the procedures and findings section:

> However, we did become aware from reading the State Agency Examination Report dated June 30, 20X1, that the following noncompliance occurred at ABC Company during the period from January 1, 20X1 through December 31, 20X1. <u>[Describe instance of noncompliance.]</u>

If the practitioners become aware of noncompliance that occurs after the period addressed by the practitioner's report but before the date of their report, they should consider adding information regarding the noncompliance to their report. In that case, a sentence such as the one illustrated in the preceding paragraph may be used to include such information.

<u>Scope Limitations.</u> When circumstances impose restrictions on the scope of the engagement that the users have not agreed to, the practitioners either should withdraw from the engagement or modify the report to describe the restriction. (When the restriction is client-imposed, the authors believe the practitioners should withdraw.) The authors believe that, if applicable, scope restrictions should be described in a separate paragraph following the

procedures and findings section using language such as, "We were unable to [Describe scope restriction.] ." The report should also contain a statement that, had the practitioners been able to perform the procedures they were unable to perform because of the scope limitation or had they performed additional procedures, other matters might have come to their attention that would have been reported.

When the client is not the responsible party, practitioners should consider the effects on their report of the responsible party's refusal to provide a written assertion or furnish written representations. Practitioners are not precluded from reporting on the engagement in those cases, but they might want to disclose in their report the inability to obtain the assertion or representations from the responsible party. (When the client is the responsible party, refusal to provide a written assertion or furnish written representations ordinarily requires the practitioner to withdraw from the agreed-upon procedures engagement.)

Explanatory Language. Where applicable, explanatory language about matters such as the following also may be included in the practitioner's report:

- Stipulated facts, assumptions, or interpretations.
- The condition of records, controls, or data to which the procedures were applied.
- That the practitioner has no responsibility to update his or her report.
- The sampling risk related to performance of the agreed-upon procedures.

Examination Engagement

Overview of the Engagement. The objective of an examination engagement is to express an opinion about an entity's compliance with specified requirements (or an assertion about compliance) based on the specified criteria. To express such an opinion, practitioners accumulate sufficient evidence about the entity's compliance with specified requirements, thereby limiting attestation risk to an appropriately low level. A practitioner may also be engaged to examine the effectiveness of an entity's internal control over compliance or an assertion about the effectiveness of internal control. If a practitioner determines that appropriate criteria exist for internal control over compliance, the engagement should be performed in accordance with AT 101. In addition, AT 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated Within an Audit of Its Financial Statements*, may be helpful to a practitioner in such an engagement.

Reporting Requirements. The practitioner may examine and report directly on an entity's compliance with specified requirements or on the responsible party's written assertion about compliance. However, when the examination discloses material noncompliance, the practitioner should modify the report and, to most effectively communicate with the users, should express his or her opinion directly on compliance (the subject matter), not on the assertion. In addition, nothing precludes the practitioner from examining an assertion but opining directly on compliance. The practitioner's examination report should include the following elements:

a. A title that includes the word *independent*.

b. Identification of the specified compliance requirements (or the responsible party's assertion about the entity's compliance with specified requirements), including the period covered, and identification of the responsible party. (When reporting on an assertion, and the assertion does not accompany the practitioner's report, the first paragraph of the report should also state the assertion.)

c. A statement that compliance with the specified requirements is the responsibility of the responsible party (the entity's management).

d. A statement that the practitioner's responsibility is to express an opinion on the entity's compliance (or the responsible party's assertion about the entity's compliance) with those requirements based on his or her examination.

e. A statement that the examination was conducted in accordance with "attestation standards established by the American Institute of Certified Public Accountants," and accordingly, included procedures considered necessary in the circumstances.

f. A statement that the practitioner believes the examination provides a reasonable basis for his or her opinion.

g. A statement that the examination does not provide a legal determination on the entity's compliance.

h. The practitioner's opinion on whether (1) the entity complied, in all material respects, with specified requirements based on the specified criteria or (2) the responsible party's assertion about compliance with specified requirements is fairly stated in all material respects based on the specified criteria.

i. A statement restricting the use of the report to specified parties in certain circumstances.

j. The manual or printed signature of the practitioner's firm.

k. The date of the examination report.

Illustrative Examination Report on an Entity's Assertion about Compliance. Presented below is an illustration of an examination report on the responsible party's (that is, the entity's management) assertion about whether the entity complied with specified requirements.

INDEPENDENT ACCOUNTANT'S REPORT

To ABC Company[a]

We have examined management's assertion, included in the accompanying Management's Report on Compliance with Loan Provisions, that ABC Company complied with Items f.–h. in the Loan Indenture during the period January 1, 20X1 through December 31, 20X1.[b, c] Management is responsible for ABC Company's compliance with those requirements. Our responsibility is to express an opinion on management's assertion about ABC Company's compliance 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 ABC Company's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination does not provide a legal determination on ABC Company's compliance with specified requirements.[d]

In our opinion, management's assertion that ABC Company complied with the aforementioned requirements during the period January 1, 20X1 through December 31, 20X1 is fairly stated, in all material respects.[e]

This report is intended solely for the information and use of the audit committee, management, and XYZ Bank and is not intended to be and should not be used by anyone other than these specified parties.[f]

Firm's Signature

City, State
February 15, 20X2[g]

Notes:

[a] The report ordinarily should be addressed to the entity, not to the specified parties. There may be situations, however, when it might be appropriate to address the report to the specified parties also.

[b] A practitioner may be engaged to report as of a point in time rather than for a period of time. In that case, the report should be revised appropriately.

[c] Usually, the reference to the assertion also includes a reference to the title of the management report that contains it. Practitioners should use the same title used by management when referring to their report. Practitioners should also use the same description of compliance requirements that management uses in their report. If the assertion does not accompany the report (that is, if the assertion is presented in a representation letter), the phrase "included in the accompanying [title of management report] " should be omitted.

[d] When evaluating compliance with specified requirements, practitioners might have to rely on interpretations of the laws, regulations, rules, contracts, or grants establishing those requirements. When the interpretations are considered significant, the practitioner should consider including a paragraph stating the description and source of the interpretations made by the entity's management. An example of such a paragraph, which should immediately follow the scope paragraph, follows:

> We have been informed that, under ABC Company's interpretation of Item f., working capital as of December 31, 20X1, includes goodwill and patent rights.

[e] Often, criteria will be included in the compliance requirements, in which case it is not necessary to repeat the criteria in the practitioner's report. However, if the criteria are not included in the compliance requirements, the practitioner's report should identify the criteria. For example, if one of the compliance requirements included in Items f.–h. in the Loan Indenture is to "maintain $25,000 in working capital," it is not necessary to repeat the $25,000 in the practitioner's report. However, if the requirement is to "maintain adequate working capital," the practitioner should identify the criteria used to define "adequate." If it is necessary to identify the criteria, they should be identified in the opinion paragraph. For example, the opinion paragraph may state ". . . in all material respects, based on the criteria set forth in Attachment 1."

[f] In some cases, criteria that have been specified by management and other report users may be appropriate for general use. In that case, this restricted-use paragraph would not be required. However, the practitioner is not precluded from restricting the use of any report.

[g] The report should be dated as of the completion of the examination procedures.

Illustrative Examination Report on Compliance with Specified Requirements. Presented below is an illustration of an examination report on the entity's compliance with specified requirements (i.e., expressing an opinion on the subject matter of the engagement).

INDEPENDENT ACCOUNTANT'S REPORT

To ABC Company

We have examined ABC Company's compliance with Items f.–h. in the Loan Indenture during the period January 1, 20X1 through December 31, 20X1. Management is responsible for ABC Company's compliance with those requirements. Our responsibility is to express an opinion on ABC Company's compliance 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 ABC Company's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination does not provide a legal determination on ABC Company's compliance with specified requirements.

In our opinion, ABC Company complied, in all material respects, with the aforementioned requirements during the period January 1, 20X1 through December 31, 20X1.

> This report is intended solely for the information and use of the audit committee, management, and XYZ Bank and is not intended to be and should not be used by anyone other than these specified parties.

Report Modifications. Practitioners should modify the standard examination reports described above for any of the following:

- Material noncompliance with specified requirements.
- Scope limitations.
- A decision to refer to the report of another practitioner as the basis, in part, for the practitioner's report.

Material Noncompliance. The practitioner may examine and report directly on an entity's compliance with specified requirements or on the responsible party's written assertion about compliance. In forming his or her opinion, the practitioner should consider (a) the nature and frequency of any noncompliance identified and (b) whether the noncompliance is material in relation to the nature of the compliance requirements. When the examination discloses material noncompliance, the practitioner should modify the report and, to most effectively communicate with the users, should express his or her opinion directly on compliance (the subject matter), not on the assertion. In that case, the practitioners should issue either a qualified or adverse opinion (depending on the materiality of the noncompliance) and add an explanatory paragraph to the report (before the opinion paragraph) describing the noncompliance. The explanatory paragraph might read as follows:

> Our examination disclosed the following material noncompliance with Item g. of the Loan Indenture applicable to ABC Company during the period January 1, 20X1 through December 31, 20X1. [Describe noncompliance.]

The opinion paragraph for a qualified opinion might read as follows:

> In our opinion, except for the material noncompliance described in the third paragraph, ABC Company complied, in all material respects, with the aforementioned requirements during the period January 1, 20X1 through December 31, 20X1.

The opinion paragraph for an adverse opinion might read as follows:

> In our opinion, because of the effect of the noncompliance described in the third paragraph, ABC Company has not complied with the aforementioned requirements during the period January 1, 20X1 through December 31, 20X1.

If the practitioner's report on an examination of the entity's compliance with specified requirements is included in a document that also includes his or her audit report on the entity's financial statements, the following sentence should be included in the explanatory paragraph of the examination report describing the material noncompliance:

> These conditions were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X1 financial statements, and this report does not affect our report dated [date of report] on those financial statements.

The practitioner may also want to include the preceding sentence when the two reports are not included in the same document.

If practitioners become aware of noncompliance that occurs subsequent to the period being reported on but before the date of the practitioners' report, they should consider whether such information should be disclosed to keep users from being misled. If so, they should add an explanatory paragraph to their report describing the noncompliance.

Scope Limitations. When circumstances impose restrictions on the scope of the engagement, practitioners should either (a) express a qualified opinion, (b) disclaim an opinion, or (c) withdraw from the engagement. The practitioner's decision to issue a qualified opinion, disclaim an opinion, or withdraw from the engagement because of a scope limitation depends on the nature and magnitude of the potential effects of the scope limitation and their significance to the entity's compliance with specified requirements or the responsible party's assertion about compliance. When restrictions that significantly limit the scope of the engagement are imposed by the client or the responsible party, the practitioner ordinarily should disclaim an opinion or withdraw from the engagement. The reasons for a qualification or disclaimer should be described in the practitioner's report.

Refusal to furnish written representations in an examination engagement is a scope limitation sufficient to preclude an unqualified opinion. Such a refusal ordinarily causes the practitioner to disclaim an opinion or withdraw from the engagement, unless he or she concludes a qualified opinion is appropriate because of the nature of the representations not obtained or the circumstances surrounding the refusal.

When practitioners are reporting on compliance and (a) a written assertion has not been provided by the responsible party and (b) the examination is required by law or regulation, the practitioners should disclaim an opinion on compliance because of the scope limitation unless evidence gathered by them warrants an adverse opinion. When practitioners issue an adverse opinion and a written assertion has not been obtained, AT 601.13 requires practitioners to restrict the use of their report. It is silent, however, with respect to the need to restrict a practitioners' report that contains a disclaimer of opinion. But the fourth standard of reporting requires practitioners to restrict their report when *reporting on subject matter and a written assertion has not been received from the responsible party*. Therefore, to be consistent with the fourth standard, practitioners generally should also restrict the use of reports containing a disclaimer of opinion when a written assertion is not received.

<u>Opinion Based in Part on Report of Another Practitioner.</u> When the practitioner's opinion is based in part on the report of another practitioner, practitioners should adapt the guidance in AT 501 to the standard reports in this section.

Restricted-use Reports. Use of the practitioner's report should be restricted to specified parties when the following conditions exist:

- The criteria used in evaluating compliance are appropriate for only a limited number of parties who either participated in establishing the criteria or who can be presumed to have an adequate understanding of the criteria.
- The criteria used in evaluating compliance are available only to specified parties.
- The practitioner is reporting on compliance and a written assertion has not been obtained from the responsible party. (The introductory paragraph of the report should also include a statement to that effect, such as "Management did not provide us a written assertion about ABC Company's compliance.")

However, practitioners are not precluded from restricting the use of any report.

A restricted-use report should contain a separate paragraph at the end of the report that (a) indicates that the report is intended solely for the information and use of the specified parties, (b) identifies the specified parties, and (c) states that the report is not intended to be and should not be used by anyone other than the specified parties. An example of such a paragraph follows:

> This report is intended solely for the information and use of <u>[Identify specified parties.]</u> and is not intended to be and should not be used by anyone other than these specified parties.

Communicating Control Deficiencies. While performing an examination engagement related to compliance with specified requirements, practitioners may become aware of significant deficiencies in the design or operation of internal control over compliance the could affect the entity's ability to comply with the specified requirements. The practitioner's responsibility to communicate those deficiencies is similar to the auditor's responsibility for communication of internal control related matters noted in an audit. If the practitioner's client is not the responsible party, the practitioner has no responsibility to communicate control deficiencies to the responsible party.

Other Information in a Client-prepared Document That Contains Management's Assertion about the Entity's Compliance with Specified Requirements or Controls over Compliance

An entity might publish various documents that contain other information in addition to the practitioner's report on the entity's compliance with specified requirements or the effectiveness of the entity's internal control over compliance or an assertion thereon. The practitioner may have performed procedures and reported on the other information. Otherwise, the practitioner's responsibility for the other information does not extend beyond information identified in the practitioner's report. Thus, practitioners have no obligation to perform any procedures on the information, other than reading it and considering whether it, or the manner of its presentation (a) is materially inconsistent with the information appearing in the practitioner's report or (b) contains a material misstatement of fact.

SOLVENCY REPORTING

In connection with a review of prospective borrowers' requests for financing, lenders sometimes request auditors to report on the prospective borrowers' solvency. In those circumstances, auditors should follow the guidance in an attestation interpretation titled *Responding to Requests for Reports on Matters Relating to Solvency* (AT 9101.23–.33). The interpretation states that in reporting on borrowers' solvency in connection with a proposed financial transaction (including, but not limited to, secured loans, recapitalizations, and leveraged buyout transactions), auditors should not provide any form of assurance, through examination, review, or agreed-upon procedures, that an entity:

- is not insolvent at the time the debt is incurred or would not be rendered insolvent thereby,
- does not have unreasonably small capital, or
- has the ability to pay its debts as they mature.

The parties to a financial transaction may use equivalent or substitute language in place of the preceding terms (e.g., fair salable value of assets exceeds liabilities). Alternative terms, however, are considered to be "matters relating to solvency" and are subject to the same prohibitions with regard to assurance.

The interpretation prohibits such assurance because matters relating to solvency are subject to varying legal interpretations. Solvency-related matters are, therefore, not clearly defined in the accounting sense and do not provide accountants with the suitable criteria needed to evaluate solvency or assertions of solvency.

If accountants are requested to provide assistance in connection with a financing, they may provide reports on a number of other services, including:

- Audit of historical financial statements.
- Review of historical financial information [under SSARS No. 1 (AR 100) for nonpublic companies or SAS No. 116 (AU 722) for interim financial information of nonpublic companies].
- Examination or review of pro forma financial information (under the attestation standard at AT 401, *Reporting on Pro Forma Financial Information*).
- Examination or compilation of, or application of agreed-upon procedures to, prospective financial statements (under the attestation standard at AT 301, *Financial Forecasts and Projections*).

Under AT 201, *Agreed-upon Procedures Engagements*, accountants also may provide clients and lenders with a report on applying agreed-upon procedures to elements, accounts, or items of a historical financial statement, pro forma financial information, or prospective financial information. They also may provide clients and lenders with reports on other matters under AT 101, *Attest Engagements*.

A report on agreed-upon procedures should not provide any assurance on the matters discussed above. According to the interpretation, the report should contain the elements required by AT 201 or AT 301 if applying agreed-upon procedures to prospective financial information. The interpretation notes that the report should also:

- State that the service has been requested in connection with a financing (no reference should be made to any solvency provisions in the financing agreement).
- State that no representations are provided regarding questions of legal interpretation.
- State that no assurance is provided concerning the borrower's (a) solvency, (b) adequacy of capital, or (c) ability to pay its debts.
- State that the procedures should not be taken to supplant any additional inquiries and procedures that the lender should undertake in its consideration of the proposed financing.
- Where applicable, state that an audit of recent historical financial statements has previously been performed and that no audit of any historical financial statements for a subsequent period has been performed. In addition, if other services have been performed, they may be referred to.

The report ordinarily is dated at the transaction closing date, or shortly before. The financing agreement usually will specify the date (commonly referred to as the cutoff date) to which the report is to relate (for example, a date five business days before the report). The report should state that the inquiries and other procedures performed did not cover the period between the cutoff date and the date of the report.

It is a good idea to provide clients with a draft of the agreed-upon procedures report that includes all the matters expected to be included in the final report. The draft copy provides clients and lenders an opportunity to make desired changes in the financing agreement or the agreed-upon procedures. The draft report should clearly be marked as a draft to avoid giving the impression that the procedures described in it already have been performed.

An attestation interpretation at AT 9101.40–.42 states that the attestation interpretation at AT 9101.23–.33 prohibiting accountants from providing any form of assurance on solvency does not apply when accountants are engaged to provide expert witness testimony.

CONSULTING ENGAGEMENTS REPORTING

Authoritative Literature

A fast-growing part of the accounting profession is the offering of business advice and counsel to clients. As the business environment becomes more complex and businessmen become more cost conscious, increasingly they turn to their accountants for information and recommendations concerning organizational, operational, financial, and other aspects of their business. Such services may be related to the audit, tax, and SSARS services the accountants provide to clients and may be rendered on a formal or informal basis. For example, accountants might respond to a client's telephone inquiry about the tax effects of a particular transaction, or they might be engaged to assess the efficiency of a company's inventory management procedures.

Statement on Standards for Consulting Services (SSCS) No. 1, *Definitions and Standards*, (CS 100) applies to a wide range of consulting services, from providing informal advice to formal engagements. The standards described in SSCS No. 1 are intended to help ensure that these services are conducted in the professional manner for which CPAs are generally noted.

Accountants need to understand when management consulting standards apply to their activities and when other AICPA standards apply. SSCS No. 1 (CS 100) applies to every AICPA member in public practice that provides a client with any of the services it describes. SSCS No. 1 defines consulting services as "professional services that employ the practitioner's technical skills, education, observations, experiences, and knowledge of the consulting process." SSCS No. 1 groups consulting services into six categories:

- Consultations.
- Advisory services.
- Implementation services.
- Transaction services.
- Staff and other support services.
- Product services.

Consulting services encompass such a broad area of activity that some practitioners may be surprised to find out that they have been routinely performing consulting services to which SSCS apply.

Consultations. The practitioner provides counsel in a short time frame based mostly, if not entirely, on the practitioner's existing personal knowledge about the client, the circumstances, the technical matters involved, client representations, and the mutual intent of the parties. Examples of consultations include reviewing and commenting on a client-prepared business plan and suggesting computer software for a further client investigation.

Advisory Services. The practitioner develops findings, conclusions, and recommendations for client consideration and decision making. Examples of advisory services include an operational review and improvement study, analysis of an accounting system, and defining the requirements for an information system.

Implementation Services. The practitioner puts an action plan or recommendations into effect. Client personnel and resources may be pooled with the practitioner's to accomplish the implementation objectives. The practitioner is responsible to the client for the conduct and management of engagement activities. Examples of implementation services include providing computer system installation and support, executing steps to improve productivity, and assisting with the mergers of organizations.

Transaction Services. The practitioner provides services relating to a specific transaction, generally with a third party. The practitioner's obligation is to the client, not to the third party. Examples of transaction services are insolvency services, valuation services, preparation of information for obtaining financing, analysis of a potential merger or acquisition, and litigation services.

Staff and Other Support Services. The practitioner provides appropriate staff and possibly other support to perform tasks specified by the client. The staff provided will be directed by the client as circumstances require. Examples of staff and other support services include data processing facilities management, computer programming, bankruptcy trusteeship, and controllership activities.

Product Services. The practitioner provides the client with a product and associated professional services in support of the installation, use, or maintenance of the product. Examples of product services include the sale or delivery of packaged software training programs, the sale and implementation of computer software, and the sale and installation of systems development methodologies.

Distinctions from Other Professional Services

SSCS No. 1 (CS 100) differentiates consulting services from other professional services a CPA may provide. A footnote in SSCS No. 1 indicates:

> The definition of consulting services excludes the following:
>
> a. Services subject to other AICPA Technical Standards such as:
>
>   - Statements on Auditing Standards (SASs).
>   - Statements on Standards for Attestation Engagements (SSAEs).

- Statements on Standards for Accounting and Review Services (SSARSs).

These excluded services may be performed in conjunction with consulting services, but only the consulting services are subject to the SSCS.

b. Engagements specifically to perform tax return preparation, tax planning/advice, tax representation, personal financial planning, or bookkeeping services; or situations involving the preparation of written reports or the provision of oral advice on the application of accounting principles to specified transactions or events, either completed or proposed, and the reporting thereof.

c. Recommendations and comments prepared during the same engagement as a direct result of observations made while performing the excluded services.

Thus, the above footnote excludes from the definition of consulting services such services as providing a management letter as part of an audit, reports on internal control, or engagements on prospective financial information.

Independence and Consulting Services

SSCS No. 1 (CS 100) specifically states that "performance of consulting services for an attest client does not, in and of itself, impair independence." A practitioner should evaluate each consulting engagement performed for an attest client and consider whether the services performed might impair independence based on the standards issued by the AICPA, state boards of accountancy, state CPA societies, or regulatory agencies that apply to that client.

General Standards and Consulting Services

According to SSCS No. 1 (CS 100), the general standards of Ethics Rule 201 in the *Code of Professional Conduct* (ET 201) apply to consulting services. Rule 201 concerns professional competence, due professional care, planning and supervision, and sufficient relevant data as a basis for conclusions or recommendations.

Communications with Client

SSCS No. 1 (CS 100) requires the practitioner to inform the client of:

- Conflicts of interest that may occur pursuant to interpretations of Rule 201.
- Significant reservations concerning the scope or benefits of the engagement.
- Significant engagement findings or events.

SSCS No. 1 (CS 100) does not preclude oral communications of these matters. The practitioner's professional judgment determines which communications must be written and which may be oral. Best practices indicate however, that the consultant should provide the client a written communication at the conclusion of an engagement unless it is an informal consultation or unless the circumstances of the engagement dictate that a written report is inappropriate (for example, in a litigation support engagement).

AUTHORITATIVE LITERATURE ON "SPECIAL REPORTS" SUMMARY

Exhibit 2-3 presents a "Summary of the Authoritative Literature on Special Reports" to help auditors select the authoritative guidance that is appropriate for the many types of reporting situations that they encounter in practice.

Exhibit 2-3

Summary of the Authoritative Literature on "Special Reports"

Reporting Situation	Authoritative Literature
1. Financial statements prepared on an other comprehensive basis of accounting (OCBOA), i.e., cash, tax, and regulatory bases, or definite set of criteria having substantial support	SAS No. 62, *Special Reports*, at AU 623.02–.10
2. Specified elements, accounts, or items of financial statements:	
a. Auditors express an opinion	SAS No. 62 at AU 623.11–.18
b. Practitioners apply agreed-upon procedures	SSAE No. 10 at AT 201, *Agreed-Upon Procedures Engagements*
c. Practitioners review the elements, accounts, or items	SSAE No. 10 at AT 101, *Attest Engagements*
d. Practitioners compile the elements, accounts, or items	SSARS No. 13, *Compilation of Specified Elements, Accounts, or Items of a Financial Statement*
3. Reporting on compliance with aspects of contractual agreements or regulatory provisions related to audited financial statements	SAS No. 62 at AU 623.19–.21
4. Special-purpose financial presentation that is incomplete but otherwise conforms with GAAP or OCBOA	SAS No. 62 at AU 623.23–.26
5. Special-purpose financial presentation prepared on a basis prescribed in an agreement that results in a presentation that departs from GAAP and OCBOA	SAS No. 62 at AU 623.27–.30
6. Prescribed forms	SAS No. 62 at AU 623.32–.33
7. Financial statements of companies in insolvency and bankruptcy proceedings	Auditing Interpretation, "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting," at AU 9508.33–.37
8. Reporting on the application of accounting principles	SAS No. 50, as amended by SAS No. 97, *Reports on the Application of Accounting Principles*, at AU 625
9. Attest engagements:	
a. Examinations	SSAE No. 10 at AT 101, *Attest Engagements*
b. Reviews	SSAE No. 10 at AT 101, *Attest Engagements*
c. Agreed-upon procedures	SSAE No. 10 at AT 201, *Agreed-Upon Procedures Engagements*
10. Prospective financial information	SSAE No. 10 at AT 301, *Financial Forecasts and Projections*, and the companion *Guide for Prospective Financial Information*
11. Pro forma financial information:	
a. Examinations or reviews	SSAE No. 10 at AT 401, *Reporting on Pro Forma Financial Information*
b. Agreed-upon procedures	SSAE No. 10 at AT 201, *Agreed-Upon Procedures Engagements*

Reporting Situation	Authoritative Literature
c. Compilations	SSARS No. 14, *Compilation of ProForma Financial Information*
12. Reports on the effectiveness of an entity's internal control over financial reporting (or an assertion thereon)	
a. Examinations	SSAE No. 15 at AT 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements*
b. Agreed-upon procedures	SSAE No. 10 at AT 201, *Agreed-Upon Procedures Engagements*
13. Reports on compliance with specified requirements and the effectiveness of the entity's internal control over compliance (or an assertion thereon)	
a. Agreed-upon procedures	SSAE No. 10 at AT 601, *Compliance Attestation*
b. Examinations	SSAE No. 10 at AT 601, *Compliance Attestation*
14. Matters relating to solvency	Attestation Interpretation, "Responding to Requests for Reports on Matters Relating to Solvency," at AT 9101.23–.33
15. Consulting services	Statement on Standards for Consulting Services at CS 100

* * *

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

27. The practitioner should obtain a written assertion concerning the entity's compliance with specified requirements or internal control over compliance from the party responsible for the compliance. The responsible party, generally the entity's management, may present the necessary written assertion in either of two forms. Which of the following is **not** one of the two forms that are acceptable?

    a. A written assertion within the practitioner's report.

    b. A separate companion report to the practitioner's report.

    c. A representation letter to the practitioner.

28. In addition to the guidance contained in AT 601, a practitioner engaged to perform agreed-upon procedures related to compliance with specified requirements or internal control over compliance should also comply with guidance contained in:

    a. AT 101.

    b. AT 201.

    c. AT 301.

    d. AT 401.

29. The practitioner's report on an agreed-upon procedures engagement accomplishes which of the following?

    a. Discloses any noncompliance.

    b. Assess the instances of noncompliance.

    c. Judges the significance of noncompliance.

30. SSCS No. 1 groups consulting services into six distinct categories. Which of the following is **not** one of those categories?

    a. Preliminary services.

    b. Advisory services.

    c. Transaction services.

    d. Product services.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

27. The practitioner should obtain a written assertion concerning the entity's compliance with specified requirements or internal control over compliance from the party responsible for the compliance. The responsible party, generally the entity's management, may present the necessary written assertion in either of two forms. Which of the following is **not** one of the two forms that are acceptable? **(Page 302)**

    a. A written assertion within the practitioner's report. [This answer is correct. A written assertion would not be integrated within the practitioner's report because it should be a separate report accompanying the practitioner's report or a representation letter to the practitioner.]

    b. A separate companion report to the practitioner's report. [This answer is incorrect. The written assertion may be presented in one of two forms. One such form is a separate report that will accompany the practitioner's report.]

    c. A representation letter to the practitioner. [This answer is incorrect. A representation letter to the practitioner is one form the written assertion may be presented in by the responsible party.]

28. In addition to the guidance contained in AT 601, a practitioner engaged to perform agreed-upon procedures related to compliance with specified requirements or internal control over compliance should also comply with guidance contained in: **(Page 303)**

    a. AT 101. [This answer is incorrect. AT 101 provides guidance regarding attest engagements.]

    b. AT 201. [This answer is correct. AT 201 provides guidance for performance and reporting in all agreed-upon procedures engagements.]

    c. AT 301. [This answer is incorrect. AT 301 provides guidance regarding financial forecasts and projections.]

    d. AT 401. [This answer is incorrect. AT 401 provides guidance regarding reporting on pro forma financial information.]

29. The practitioner's report on an agreed-upon procedures engagement accomplishes which of the following? **(Page 306)**

    a. Discloses any noncompliance. [This answer is correct. The objective of an agreed-upon procedures engagement is to provide users with information regarding compliance with specified requirements or the effectiveness of internal control over compliance. Therefore, the report simply describes the results of procedures performed and discloses any noncompliance or ineffective controls over compliance (if applicable) that the practitioner becomes aware of.]

    b. Assess the instances of noncompliance. [This answer is incorrect. Since the practitioner's report on an agreed-upon procedures engagement does not provide an opinion, the practitioner does not assess the instances of noncompliance.]

    c. Judges the significance of noncompliance. [This answer is incorrect. Judging the significance would be providing an opinion, and the practitioner does not provide an opinion in his or her report on an agreed-upon procedures engagement.]

30. SSCS No. 1 groups consulting services into six distinct categories. Which of the following is **not** one of those categories? **(Page 313)**

    a. Preliminary services. [This answer is correct. Preliminary services are not identified in SSCS No. 1 as one of the six categories of consulting services. The six categories are consultations, advisory services, implementation services, transaction services, staff and other support services, and product services.]

b. Advisory services. [This answer is incorrect. Advisory services are one of the six categories into which SSCS No. 1 groups consulting services. The practitioner develops findings, conclusions, and recommendations for client consideration and decision making. Examples include an operational review and improvement study, analysis of an accounting system, and defining the requirements for an information system.]

c. Transaction services. [This answer is incorrect. SSCS No. 1 lists transaction services as one of six categories of consulting services. The practitioner provides services relating to a specific transaction, generally with a third party. The practitioner's obligation is to the client, not to the third party. Examples include insolvency services, valuation services, preparation of information for obtaining financing, analysis of a potential merger or acquisition, and litigation services.]

d. Product services. [This answer is incorrect. Another of the six categories of consulting services is product services. The practitioner provides the client with a product and associated professional services in support of the installation, use, or maintenance of the product. Examples include the sale or delivery of packaged software training programs, the sale and implementation of computer software, and the sale and installation of systems development methodologies.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (GARTG093)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

15. If an auditor needs guidance concerning the performance of attest engagements on management's discussion and analysis (MD&A) for a public company, which of the following sections of SSAE No. 10 should be used?

    a. AT 101.

    b. AT 201.

    c. AT 601.

    d. AT 701.

16. SSAE No. 14 identifies which of the following attest publications as being those the practitioner must comply with when conducting attest engagements?

    a. Continuing professional education programs.

    b. Attestation publications from state CPA societies.

    c. Statements on Standards for Attestation Engagements.

    d. The Journal of Accountancy.

17. As precisely stated below, which of the following engagements is an attest engagement?

    a. Engagements where practitioners are engaged to issue a review on subject matter that is the responsibility of another party.

    b. Engagements where practitioners are engaged to advocate a client's position on tax matters being review by the Internal Revenue Service.

    c. Engagements that are performed pursuant to Statements on Standards for Accounting and Review Services.

    d. Engagements where practitioners provide tax advice or prepare a client's tax return.

18. Practitioners who perform attest engagements should either issue a report on the subject matter or:

    a. Disclaim an opinion.

    b. Issue an unqualified opinion.

    c. Withdraw from the engagement.

    d. Justify why a report was not issued.

19. Depending on the form the practitioner's review report takes, it should include a number of elements. One element is a title that includes which of the following words?

    a. Preliminary.

b. Independent.

c. Contingent.

d. Final.

20. If a practitioner believes that other information in client-prepared documents that contain the practitioner's attest report is inconsistent with the information appearing in the practitioner's report and he or she determines that his or her report does not require revision, what is the next step he or she should take as a result of the material inconsistency?

    a. Revise their report to include an explanatory paragraph.

    b. Request management to revise the other information.

    c. Withhold the use of their report in the document.

    d. Withdraw from the engagement.

21. When a practitioner agrees to the inclusion of his or her agreed-upon procedures report in a document containing unaudited financial statements of a nonpublic entity, guidance in which of the following documents should be followed regarding the practitioner's responsibility related to the financial statements?

    a. SSARS No. 1 (AR 100), *Compilation and Review of Financial Statements*.

    b. SAS No. 26 (AU 504), *Association with Financial Statements*.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

22. Which of the following statements is accurate regarding the practitioner's responsibilities in performing agreed-upon procedures engagements?

    a. Procedures should be performed solely by the practitioner (assistance by a specialist is not permitted).

    b. Practitioners are permitted to use schedules provided by internal auditors in performing procedures.

    c. Practitioners can take responsibility for procedures performed by internal auditors.

    d. Practitioners can indicate in their report that they shared performance of responsibilities with internal auditors.

23. A practitioner's report on applying agreed-upon procedures should include/identify a number of elements. Which of the following is **inaccurate** regarding elements that should be included or identified?

    a. Responsible party identification.

    b. Subject matter and character of the engagement identification.

    c. Manual only (not printed) signature of practitioner's firm

    d. Identification of specified parties.

24. Although not defined in AT 301, it is generally accepted that third parties include all of the following **except**:

    a. Management stockholders.

b. Bankers.

c. Regulatory agencies (government).

d. General public.

25. A prospective financial statement may be classified as either a forecast or a projection. Which of the following statements is accurate regarding a forecast?

    a. It is based on the responsible party's assumptions reflecting conditions it expects would exist and the course of action it expects would be taken, given one or more hypothetical assumptions.

    b. It is based on the responsible party's assumptions reflecting conditions it expects to exist and the course of action it expects to take without hypothetical assumptions.

    c. It has only limited use and is only appropriate for use by the responsible party or third parties with whom the responsible party is negotiating directly.

    d. The title given to this type of prospective financial statement should refer to the significant hypothetical assumption on which it is based.

26. Generally, most requests for examinations or reviews of pro forma financial information will be made by:

    a. Public companies.

    b. Nonpublic companies.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

27. A practitioner's risk of lawsuits generally is lower in which of the following types of engagements?

    a. Examination engagement.

    b. Agreed-upon procedures engagement.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

28. If a practitioner is asked to provide advice on improvements in compliance or internal control over compliance with specified requirements, they generally should suggest an engagement using which of the following literature?

    a. AT 601.

    b. SAS No. 72 (AU 634).

    c. SAS No. 74 (AU 801).

    d. SSCS No. 1 (CS 100).

29. Which of the following best describes a requirement that criteria must meet in order to be used to evaluate compliance?

    a. Extensive.

b. Validated.

c. Suitable.

d. Do not select this answer choice.

30. If noncompliance or ineffective controls by means other than the agreed-upon procedures are discovered by the practitioner, what action is appropriate?

a. Include such information in their report.

b. Assess whether to include such information in their report.

c. Ignore such information since not found using agreed-upon procedures.

d. Follow the direction in AT 601 regarding handling of noncompliance or ineffective controls.

GLOSSARY

Agreed-upon procedures engagement: An agreed-upon procedures engagement is one in which practitioners are engaged to report their findings based on specific procedures performed on subject matter. The engagement is performed to assist specified parties in evaluating subject matter, on an assertion about subject matter, based on their needs.

Capital lease: A lease that must be reflected on a company's balance sheet as an asset and corresponding liability. Generally, this applies to leases where the lessee acquires essentially all of the economic benefits and risks of the leased property.

Cash basis method of accounting: Accounting method used by most individual taxpayers. The cash method recognizes income and deductions when money is received or paid.

Current-value basis of accounting: Accounting method used to provide an income statement and balance sheet in terms of current dollars, in an effort to provide better financial information during an inflationary period.

Discounted cash flow: A technique used to estimate the present value of future expected cash receipts and expenditures, using Net Present Value (NPV) or Internal Rate of Return (IRR). It is a factor in analyses of both capital investments and securities investments. The NPV method applies a rate of discount (interest rate) based on the marginal cost of capital to future cash flows to express them in terms of current money. The IRR method finds the average return on investment earned through the life of the investment. It determines the discount rate that equates the present value of future cash flows to the cost of the investment.

FASB: Financial Accounting Standards Board. A private, not-for-profit organization whose primary purpose is to develop generally accepted accounting principles (GAAP) within the United States in the public's interest.

Financial position: Status of a firm's assets, liabilities, and equity accounts as of a certain time, as shown on its financial statement; also called *financial condition*.

Forecast: 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 cash flows. A financial forecast is based on the responsible party's assumptions reflecting conditions it expects to exist and the course of action it expects to take.

GAAP: Generally Accepted Accounting Principles. The term used to refer to the standard framework of guidelines for financial accounting used in any given jurisdiction. GAAP includes the standards, conventions, and rules accountants follow in recording and summarizing transactions, and in the preparation of financial statements

IFRS: International Financial Reporting Standards. Standards, interpretations and the framework for the preparation and presentation of financial statements (in the absence of a standard or an interpretation) adopted by the International Accounting Standards Board (IASB).

Liquidation: The dismantling of a business, paying off debts in order of priority, and distributing the remaining assets in cash to the owners.

Modified accrual method of accounting: Governmental accounting method. Revenue is recognized when it becomes available and measurable.

OCBOA: Other Comprehensive Basis of Accounting. In the United States, refers to a system of accounting other than GAAP.

Operating lease: An operating lease is a type of lease, normally involving equipment, whereby the contract is written for considerable less than the life of the equipment and the lessor handles all maintenance and servicing.

Projection: Prospective financial statements that present, to the best of the responsible party's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations, and cash flows.

Qualified opinion: Language in the auditor's opinion accompanying financial statements that calls attention to limitations of the audit or exceptions the auditor takes to items in the statements. Typical reasons for qualified opinions: pending lawsuit that, if lost, would materially affect the financial condition of the company; indeterminable tax liability relating to an unusual transaction; inability to confirm a portion of the inventory because of inaccessible location.

Related party transaction: Interaction between two parties, one of whom can exercise control or significant influence over the operating policies of the other. A special relationship may exist, for example, between a business enterprise and its principal owners.

Tax basis of accounting: Whatever basis of accounting is used on an entity's tax return. Typically used by smaller entities to reduce the burden of financial reporting.

INDEX

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Auditor's Reports—Course 1—The Standard Auditor's Report and Internal Control Reporting (GARTG091)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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2.	○	○	○	○	10.	○	○	○	○	18.	○	○	○	○	26.	○	○	○	○
3.	○	○	○	○	11.	○	○	○	○	19.	○	○	○	○	27.	○	○	○	○
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5.	○	○	○	○	13.	○	○	○	○	21.	○	○	○	○	29.	○	○	○	○
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Page

EXAMINATION FOR CPE CREDIT ANSWER SHEET

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3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
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9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here ________

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Auditor's Reports—Course 3—Special Reports (GARTG093)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   GARTG093 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **October 31, 2010**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Auditor's Reports—Course 3—Special Reports (GARTG093)

Price $79

First Name: ____________________

Last Name: ____________________

Firm Name: ____________________

Firm Address: ____________________

City: ____________________ State /ZIP: ____________________

Firm Phone: ____________________

Firm Fax No.: ____________________

Firm Email: ____________________

Express Grading Requested: ☐ Add $24.95

Signature: ____________________

Credit Card Number: ____________________ Expiration Date: ____________________

Birth Month: ____________________ Licensing State: ____________________

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ✓ .

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	9.	○	○	○	○	17.	○	○	○	○	24.	○	○	○	○
2.	○	○	○	○	10.	○	○	○	○	18.	○	○	○	○	25.	○	○	○	○
3.	○	○	○	○	11.	○	○	○	○	19.	○	○	○	○	26.	○	○	○	○
4.	○	○	○	○	12.	○	○	○	○	20.	○	○	○	○	27.	○	○	○	○
5.	○	○	○	○	13.	○	○	○	○	21.	○	○	○	○	28.	○	○	○	○
6.	○	○	○	○	14.	○	○	○	○	22.	○	○	○	○	29.	○	○	○	○
7.	○	○	○	○	15.	○	○	○	○	23.	○	○	○	○	30.	○	○	○	○
8.	○	○	○	○	16.	○	○	○	○										

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: October 31, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Auditor's Reports—Course 3—Special Reports

Course Acronym: GARTG093

Your Name (optional): ____________ Date: ____________

Email: ____________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
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6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
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6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _________