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# Auditing Interpretations

## of the Public Company Accounting Oversight Board

This booklet displays PCAOB auditing interpretations for audits of financial statements for fiscal years ending on or after Dec. 15, 2024.

This booklet was prepared by staff of the Office of the Chief Auditor from the auditing interpretations on the PCAOB's website. In the event of typographical or other technical errors in the interpretations presented in this document, the rule text that the PCAOB Board adopted, and the Securities and Exchange Commission ("SEC") approved as presented in the relevant SEC rule release, shall govern.

# Auditing Interpretations

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

The following is a list of PCAOB auditing interpretations for audits of financial statements for fiscal years ending on or after December 15, 2024. Downloadable PDF booklets of the auditing interpretations that are effective for audits of this and other periods are also available:

- PCAOB auditing standards for audits of financial statements for fiscal years ending on Dec. 15, 2020 through Dec. 14, 2024
- PCAOB auditing standards, as reorganized beginning Dec. 31, 2016, for audits of financial statements for fiscal years ending before Dec. 15, 2020

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# AI 11: Using the Work of a Specialist: Auditing Interpretations

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

## 1. The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140

.01 Introduction—Financial Accounting Standards Board (FASB) Statement No. 140,<sup>1</sup> *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, requires that a transferor of financial assets must surrender control over the financial assets to account for the transfer as a sale. Paragraph 9(a) states one of several conditions that must be met to provide evidence of surrender of control:

The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

Paragraph 27 of FASB Statement No. 140 describes in greater detail the evidence required to support management's assertion that transferred financial assets have been isolated:

The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or SPE might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any consolidated affiliate

of the transferor that is not a special-purpose corporation or other entity designed to make remote the possibility that it would enter bankruptcy or other receivership.

A determination about whether the isolation criterion has been met to support a conclusion regarding surrender of control is largely a matter of law. This aspect of surrender of control, therefore, is assessed primarily from a legal perspective.

.02 **Effective Date and Applicability**—This interpretation is effective for auditing procedures related to transfers of financial assets that are required to be accounted for under FASB Statement No. 140, as amended by FASB Technical Bulletin (FTB) No. 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*.<sup>2</sup>

.03 **Question**—What should the auditor consider in determining whether to use the work of a legal specialist<sup>3</sup> to obtain persuasive evidence to support management’s assertion that a transfer of financial assets meets the isolation criterion of FASB Statement No. 140?

.04 **Interpretation**—During the audit, an auditor may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor’s judgment require using the work of a specialist to obtain appropriate evidential matter.

.05 **Use of a legal specialist** may not be necessary to obtain appropriate evidential matter to support management’s assertion that the isolation criterion is met in certain situations, such as when there is a routine transfer of financial assets that does not result in any continuing involvement by the transferor.<sup>4</sup>

.06 **Many transfers of financial assets** involve complex legal structures, continuing involvement by the transferor, or other legal issues that, in the auditor’s judgment, make it difficult to determine whether the isolation criterion is met. In these situations, use of a legal specialist usually is necessary. A legal specialist formulating an opinion as to whether a transfer isolates the transferred assets beyond the reach of the transferor and its creditors may consider, among other things, the structure of the transaction taken as a whole, the nature of any continuing involvement, the type of insolvency or other receivership proceedings to which the transferor might become subject, and other factors pertinent under applicable law.

.07 **If a legal opinion is used as evidence to support the accounting conclusion related to multiple transfers under a single structure, and such transfers occur over an extended period of time under that structure, the auditor should evaluate the need for management to obtain periodic updates of that opinion to confirm that there have been no subsequent changes in relevant law or applicable regulations that may change the applicability of the previous opinion to such transfers. The auditor also should evaluate the need for management to obtain periodic updates of an opinion to confirm that there have been no subsequent changes in relevant law or applicable regulations that may affect the conclusions reached in the previous opinion in the case of other transfers (see paragraph 55 of FASB Statement No. 140).**

.08 **If management’s assertion with respect to a new transaction is that the transaction structure is the same as a prior structure for which a legal opinion that complies with this interpretation was used as evidence to support an assertion that the transfer of assets met the isolation criterion, the auditor should**

evaluate the need for management to obtain an update of that opinion to confirm that there have been no changes in relevant law, applicable regulations, or in the pertinent facts of the transaction that may affect the applicability of the previous opinion to the new transaction.

.09 *Question*—If the auditor determines that the use of a legal specialist is required, what should he or she consider in assessing the adequacy of the legal opinion?

.10 *Interpretation*—In assessing the adequacy of the legal opinion, the auditor should consider whether the legal specialist has experience with relevant matters, including knowledge of the U.S. Bankruptcy Code, and other federal, state, or foreign law, as applicable, as well as knowledge of the transaction upon which management's assertion is based. For transactions that may be affected by provisions of the Federal Deposit Insurance Act, the auditor should consider whether the legal specialist has experience with the rights and powers of receivers, conservators, and liquidating agents under that Act. The auditor should obtain an understanding of the assumptions that are used by the legal specialist, and make appropriate tests of any information that management provides to the legal specialist and upon which the specialist indicates it relied. For example, testing management's information underlying a legal specialist's assumption regarding the adequacy of consideration received may depend on the nature of the transaction and the relationship of the parties. When the legal specialist's opinion has assumed the adequacy of consideration for transfers from a particular legal entity to its wholly owned subsidiary, changes in the subsidiary's capital accounts plus other consideration generally would be sufficient audit evidence as to the adequacy of consideration. In the case of other transfers, such as those that are not to a wholly owned subsidiary of a particular legal entity that is the transferor, obtaining additional audit evidence may be necessary to evaluate management's assertion with regard to the adequacy of consideration upon which the legal specialist relied, because changes in the transferee's capital accounts do not solely benefit the transferring entity.

.11 The auditor also should consider the form and content of the documentation that the legal specialist provides and evaluate whether the legal specialist's findings support management's assertions with respect to the isolation criterion. FASB Statement No. 140's requirement regarding reasonable assurance that the transferred assets would be isolated provides the basis for what auditors should consider in evaluating the work of a legal specialist.

.12 Findings of a legal specialist that relate to the isolation of transferred financial assets are often in the form of a reasoned legal opinion that is restricted to particular facts and circumstances relevant to the specific transaction. The reasoning of such opinion may rely upon analogy to legal precedents that may not involve facts and circumstances that are comparable to that specific transaction. The auditor also should consider the effect of any limitations or disclaimers of opinion in assessing the adequacy of any legal opinion.

.13 An example of the conclusions in a legal opinion for an entity that is subject to the U.S. Bankruptcy Code that provides persuasive evidence, in the absence of contradictory evidence, to support management's assertion that the transferred financial assets have been put presumptively beyond the reach of the entity and its creditors, even in bankruptcy or other receivership, follows:

"We believe (or it is our opinion) that in a properly presented and argued case, as a legal

matter, in the event the Seller were to become a Debtor, the transfer of the Financial Assets from the Seller to the Purchaser would be considered to be a sale (or a true sale) of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement would not be deemed to be property of the Seller's estate for purposes of [the relevant sections] of the U.S. Bankruptcy Code."

The following additional paragraph addressing substantive consolidation applies when the entity to which the assets are sold (as described in the opinion) is an affiliate of the selling entity and may also apply in other situations as noted by the legal specialist. For example, if a so-called "two-step" structure has been used to achieve isolation, this paragraph usually will be required with respect to the transferee in the first step of such structure (see paragraph .15 and related footnotes for additional guidance on the second step of a two-step structure as described in paragraph 83 of FASB Statement No. 140). When the transferor has entered into transactions with an affiliate that could affect the issue of substantive consolidation, the opinion should address the effect of that involvement on the opinion.

"Based upon the assumptions of fact and the discussion set forth above, and on a reasoned analysis of analogous case law, we are of the opinion that in a properly presented and argued case, as a legal matter, in a proceeding under the U.S. Bankruptcy Code,<sup>5</sup> in which the Seller is a Debtor, a court would not grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller in a case involving the insolvency of the Seller under the doctrine of substantive consolidation."

In the case of a transferor that is not entitled to become a debtor under the U.S. Bankruptcy Code, a legal opinion regarding whether the isolation criterion is met would consider whether isolation is satisfactorily achieved under the insolvency or receivership laws that apply to the transferor.

.14 Following are two examples of the conclusions in a legal opinion for an entity that is subject to receivership or conservatorship under provisions of the Federal Deposit Insurance Act. The conclusions in these two examples provide persuasive evidence, in the absence of contradictory evidence, to support management's assertion that the transferred financial assets have been put presumptively beyond the reach of the entity and its creditors, even in conservatorship or receivership. Insolvency and receivership laws applicable to depository institutions, and how those laws affect the legal isolation criterion, differ depending upon the nature of the depository institution and its chartering authority. Accordingly, legal opinions addressing the legal isolation criterion may be formulated in different ways to accommodate those differences.<sup>6</sup>

Example 1: "We believe (or it is our opinion) that in a properly presented and argued case, as a legal matter, in the event the Seller were to become subject to receivership or conservatorship, the transfer of the Financial Assets from the Seller to the Purchaser would be considered to be a sale (or a true sale) of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement would not be deemed to be property of, or subject to repudiation, reclamation, recovery, or recharacterization by, the receiver or conservator appointed with respect to the Seller."

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Example 2: "The Federal Deposit Insurance Corporation (FDIC) has issued a regulation, 'Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation,' 12 CFR section 360.6 (the Rule). Based on and subject to the discussion, assumptions, and qualifications herein, it is our opinion that:

- A. Following the appointment of the FDIC as the conservator or receiver for the Bank:
  - (i) The Rule will apply to the Transfers,
  - (ii) Under the Rule, the FDIC acting as conservator or receiver for the Bank could not, by exercise of its authority to disaffirm or repudiate contracts under 12 U.S.C. §1821(e), reclaim or recover the Transferred Assets from the Issuer or recharacterize the Transferred Assets as property of the Bank or of the conservatorship or receivership for the Bank,
  - (iii) Neither the FDIC (acting for itself as a creditor or as representative of the Bank or its shareholders or creditors) nor any creditor of the Bank would have the right, under any bankruptcy or insolvency law applicable in the conservatorship or receivership of the Bank, to avoid the Transfers, to recover the Transferred Assets, or to require the Transferred Assets to be turned over to the FDIC or such creditor, and
  - (iv) There is no other power exercisable by the FDIC as conservator or receiver for the Bank that would permit the FDIC as such conservator or receiver to reclaim or recover the Transferred Assets from the Issuer, or to recharacterize the Transferred Assets as property of the Bank or of the conservatorship or receivership for the Bank; provided, however, that we offer no opinion as to whether, in receivership, the FDIC or any creditor of the Bank may take any such actions if the Holders [holders of beneficial interests in the transferred assets] receive payment of the principal amount of the Interests and the interest earned thereon (at the contractual yield) through the date the Holders are so paid; and
- B. Prior to the appointment of the FDIC as conservator or receiver for the Bank, the Bank and its other creditors would not have the right to reclaim or recover the Transferred Assets from the Issuer, except by the exercise of a contractual provision [insert appropriate citation] to require the transfer, or return, of the Transferred Assets that exists solely as a result of the contract between the Bank and the Issuer."<sup>8</sup>

The following additional paragraph addressing substantive consolidation applies when the entity to which the assets are sold or transferred (as described in the opinion) is an affiliate of the selling entity and may also apply in other situations as noted by the legal specialist.<sup>9</sup> For example, if a so-called two-step structure has been used to achieve isolation, the following paragraph usually will be required with respect



to the transferee in the first step of the structure (see paragraph .15 and related footnotes for additional guidance on the second step of a two-step structure as described in paragraph 83 of FASB Statement No. 140). When the transferor has entered into transactions with an affiliate that could affect the issue of substantive consolidation, the opinion should address the effect of that involvement on the opinion.

"Based upon the assumptions of fact and the discussion set forth above, and on a reasoned analysis of analogous case law, we are of the opinion that in a properly presented and argued case, as a legal matter, in a receivership, conservatorship, or liquidation proceeding in respect of the Seller, a court would not grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller."

Certain powers to repudiate contracts, recover, reclaim, or recharacterize transferred assets as property of a transferor that are exercisable by the FDIC under the Federal Deposit Insurance Act may, as of the date of the transfer, be limited by a regulation that may be repealed or amended only in respect of transfers occurring on or after the effective date of such repeal or amendment.<sup>10</sup> With respect to the powers of a receiver or conservator that may not be exercised under that regulation, it is acceptable for attorneys to rely upon the effectiveness of the limitation on such powers set forth in the applicable regulation, provided that the attorney states, based on reasonable assumptions, that: (1) the affected transfer of financial assets meets all qualification requirements of the regulation, and (2) the regulation had not, as of the date of the opinion, been amended, repealed, or held inapplicable by a court with jurisdiction with respect to such transfer. The opinion should separately address any powers of repudiation, recovery, reclamation, or recharacterization exercisable by a receiver or conservator notwithstanding that regulation (for example, rights, powers, or remedies regarding transfers specifically excluded from the regulation) in a manner that provides the same level of assurance as would be provided in the case of opinions that conform with requirements of paragraph .13, except that such opinion shall address powers arising under the Federal Deposit Insurance Act. The considerations in the immediately preceding three sentences are adequately addressed either by the example 1 opinion or the example 2 opinion described in this paragraph or by the variations described in the second paragraph of footnote 8 and in footnote 9.

.15 A legal letter that includes an inadequate opinion, inappropriate limitations, or a disclaimer of opinion, or that effectively limits the scope of the opinion to facts and circumstances that are not applicable to the transaction, does not provide persuasive evidence to support the entity's assertion that the transferred assets have been put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Likewise, a legal letter that includes conclusions that are expressed using some of the following language would not provide persuasive evidence that a transfer of financial assets has met the isolation criterion of FASB Statement No. 140 (see paragraphs .20 and .21 of this interpretation):

- "We are unable to express an opinion . . ."
- "It is our opinion, based upon limited facts . . ."
- "We are of the view . . ." or "it appears . . ."
- "There is a reasonable basis to conclude that . . ."
-

"In our opinion, the transfer would either be a sale or a grant of a perfected security interest . . ."

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- "In our opinion, there is a reasonable possibility . . ."
- "In our opinion, the transfer should be considered a sale . . ."
- "It is our opinion that the company will be able to assert meritorious arguments . . ."
- "In our opinion, it is more likely than not . . ."
- "In our opinion, the transfer would presumptively be . . ."
- "In our opinion, it is probable that . . ."

Furthermore, conclusions about hypothetical transactions may not be relevant to the transaction that is the subject of management's assertions. Paragraph .06 of AS 1105, *Audit Evidence*, states, "[t]o be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based." Additionally, conclusions about hypothetical transactions may not contemplate all of the facts and circumstances or the provisions in the agreements of the transaction that is the subject of management's assertions, and generally would not provide persuasive evidence.<sup>12</sup>

.16 *Question*—Are legal opinions that restrict the use of the opinion to the client, or to third parties other than the auditor, acceptable audit evidence?

.17 *Interpretation*—No. In some cases, the auditor may decide it is necessary to contact the specialist to determine that the specialist is aware that his or her work will be used for evaluating the assertions in the financial statements. Given the importance of the legal opinion to the assertion in this case, and the precision that legal specialists use in drafting such opinions, an auditor should not use as evidence a legal opinion that he or she deems otherwise adequate if the letter restricts use of the findings expressed therein to the client or to third parties other than the auditor. In that event, the auditor should request that the client obtain the legal specialist's written permission for the auditor to use the opinion for the purpose of evaluating management's assertion that a transfer of financial assets meets the isolation criterion of FASB Statement No. 140.

.18 An example of a letter from a legal specialist to a client that adequately communicates permission for the auditor to use the legal specialist's opinion for the purpose of evaluating management's assertion that a transfer of financial assets meets the isolation criterion of FASB Statement No. 140 is as follows:

"Notwithstanding any language to the contrary in our opinions of even date with respect to certain bankruptcy issues relating to the above-referenced transaction, you are authorized to make available to your auditors such opinions solely as evidential matter in support of their evaluation of management's assertion that the transfer of the receivables meets the isolation criterion of FASB Statement No. 140, provided a copy of this letter is furnished to them in connection therewith. In authorizing you to make copies of such opinions available to your auditors for such purpose, we are not undertaking or assuming any duty or obligation to your auditors or establishing any lawyer-client relationship with them. Further, we do not undertake or assume any responsibility with respect to

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financial statements of you or your affiliates."

.19 A letter from a legal specialist to a client might authorize the client to make copies of the legal opinion available to the auditor to use in his or her evaluation of management's assertion that a transfer of financial assets meets the isolation criterion of FASB Statement No. 140, but then state that the auditor is not authorized to rely thereon. Such "use but not rely on" language, or other language that similarly restricts the auditor's use of the legal specialist's opinion, does not adequately communicate permission for the auditor to use the legal specialist's opinion as evidential matter. The auditor may wish to consult with his or her legal counsel in circumstances where it is not clear that the auditor may use the legal specialist's opinion.

.20 *Question*—If the auditor determines that it is appropriate to use the work of a legal specialist, and either the resulting legal response does not provide persuasive evidence that a transfer of assets has met the isolation criterion, or the legal specialist does not grant permission for the auditor to use a legal opinion that is restricted to the client or to third parties other than the auditor, what other steps might an auditor consider?

.21 *Interpretation*—When other relevant evidential matter exists, the auditor should consider it before reaching a conclusion about the appropriateness of management's accounting for a transfer. However, since the isolation aspect of surrender of control is assessed primarily from a legal perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion. In the absence of persuasive evidence that a transfer has met the isolation criterion, derecognition of the transferred assets is not in conformity with generally accepted accounting principles and the auditor should consider the need to express a qualified or adverse opinion in accordance with paragraphs .18 through .43 of AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*. However, if permission for the auditor to use a legal opinion that he or she deems otherwise adequate is not granted, this would be a scope limitation and the auditor should consider the need to express a qualified opinion or to disclaim an opinion in accordance with AS 3105.05–.09 and AS 3105.44–.47.

### Footnotes - AI 11: Using the Work of a Specialist: Auditing Interpretations

<sup>1</sup> Financial Accounting Standards Board (FASB) Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, is a replacement of FASB Statement No. 125 and is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001, except as provided in paragraphs 19–25 of FASB Statement No. 140 as amended by FASB Technical Bulletin (FTB) No. 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*.

<sup>2</sup> FTB No. 01-1 amends FASB Statement No. 140 to change the effective date for paragraphs 9(a), 27, 28, and 80–84 of FASB Statement No. 140 for transfers of financial assets by certain financial institutions. Paragraphs 6–8 of FTB No. 01-1 also provide additional transition time for transfers by financial institutions to certain master trusts.

<sup>3</sup> Client's internal or external attorney who is knowledgeable about relevant sections of the U.S.

Bankruptcy Code and other federal, state, or foreign laws, as applicable.

<sup>4</sup> FASB Emerging Issues Task Force Topic No. D-99, *Questions and Answers Related to Servicing Activities in a Qualifying Special-Purpose Entity under FASB Statement No. 140*, characterizes no continuing involvement with the transferred assets as "no servicing responsibilities, no participation in future cash flows, no recourse obligations other than standard representations and warranties that the financial assets transferred met the delivery requirements under the arrangement, no further involvement of any kind."

If a contractual provision (such as a call or removal of accounts provision) gives the transferor the unilateral ability to require the return of specific financial assets, the auditor should consider the effect of paragraph 9(c) of FASB Statement No. 140.

<sup>5</sup> For an entity subject to additional regulation (*e.g.*, a broker-dealer subject to the Securities Investor Protection Act), the legal opinion also generally should address the effect of such regulation and the policies of the regulators implementing such regulations (*e.g.*, the Securities Investor Protection Corporation).

<sup>6</sup> For an entity subject to conservatorship or liquidation under the National Credit Union Act, the examples and discussion in this paragraph would be modified to make appropriate references to "liquidation" and "liquidating agent" and additional information relating to rights and regulations of the National Credit Union Administration.

<sup>7</sup> When the opinion indicates that isolation is achieved without reference to a true sale, the opinion also should provide reasonable assurance that the transferred assets are beyond the reach of the transferor and its creditors other than the transferee to the same extent that is provided in example 2, paragraph B.

<sup>8</sup> See the second paragraph of footnote 4.

Paragraph B is not required if the opinion includes both a conclusion, as set forth in example 1, that the transfer constitutes a "true sale" and the conclusions set forth of example 2, paragraph A. It is not necessary to include any provision of example 2 if the opinion is as set forth in example 1.

<sup>9</sup> An additional substantive consolidation opinion is not required if the opinion states that its conclusion includes the inability to recover the transferred financial assets or recharacterize the transfer by application of the doctrine of "substantive consolidation."

<sup>10</sup> The applicable regulation is 12 CFR section 360.6, effective September 11, 2000.

<sup>11</sup> Certain transferors are subject only to receivership (and not to proceedings under the U.S. Bankruptcy Code or the Federal Deposit Insurance Act) under laws that do not allow a receiver to reach assets in which a security interest has been granted. In such circumstances, an opinion that concludes that the transfer would either be a sale or a grant of a security interest that puts the transferred assets beyond the reach of such receiver and other creditors would provide persuasive evidence that the isolation criterion is met. In certain circumstances, a legal specialist may provide an opinion on both steps of a two-step structure. Such language would be acceptable in an opinion for a transfer of assets in the second step of a two-step structure as described in paragraph 83 of FASB Statement No. 140 provided that the opinion on the transfer in the first step is consistent with paragraphs .13 or .14 of this interpretation.

<sup>12</sup> For example, a memorandum of law from a legal specialist usually analyzes (and may make conclusions about) a transaction that may be completed subsequently. Such memorandum generally would not provide persuasive evidence unless the conclusions conform with this interpretation and a legal specialist opines that such conclusions apply to a completed transaction that is the subject of management's assertion.

<sup>13</sup> This language may appear in the legal specialist's opinion rather than in a separate letter. In that case, the wording would be modified slightly to indicate the context.

<sup>[14]</sup> [Footnote deleted.]

# AI 12: Communications About Control Deficiencies in an Audit of Financial Statements: Auditing Interpretations of AS 1305

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

View AS 1305, *Communications About Control Deficiencies in an Audit of Financial Statements*

Note: In an audit of financial statements only, auditing interpretation 1 to AS 1305, *Communications About Control Deficiencies in an Audit of Financial Statements*, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph .02 of this standard. Within the example report within paragraph 4 of the interpretation, the third sentence is replaced with the definition of a material weakness in paragraph .A7 of Appendix A, *Definitions*, of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

## 1. Reporting on the Existence of Material Weaknesses

.01 *Question*—AS 1305 requires the auditor to report to the audit committee or to individuals with equivalent authority and responsibility significant deficiencies noted during an audit of financial statements. It permits the issuance of reports that include a statement about whether any of the significant deficiencies identified are material weaknesses. In connection with an audit, may the auditor issue a written report on material weaknesses separate from the report on significant deficiencies?

.02 *Interpretation*—Yes. AS 1305 does not preclude the auditor from issuing a separate report stating whether he or she noted any material weaknesses during the audit. Reports on material weaknesses should—

- Indicate that the purpose of the audit was to report on the financial statements and not to provide assurance on internal control.
- Include the definition of a material weakness.
- State that the communication is intended solely for the information and the use of the audit committee, management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. When there are requirements

established by governmental agencies to furnish such reports, specific reference to such regulatory authorities may be made.

.03 AS 1305 prohibits the auditor from issuing a written report representing that no significant deficiencies were noted during the audit. Therefore, in issuing a report stating that no material weaknesses were noted, the auditor should not imply that no significant deficiencies were noted.

.04 The following is an illustration of a report encompassing the above requirements:

In planning and performing our audit of the financial statements of ABC Corporation for the year ended December 31, 19XX, we considered its internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control. Our consideration of the internal control would not necessarily disclose all matters in the internal control that might be material weaknesses under the standards of the Public Company Accounting Oversight Board (United States). A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control and its operation that we consider to be material weaknesses as defined above.

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the organization (or specified regulatory agency) and is not intended to be and should not be used by anyone other than these specified parties.

.05 If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention. The last sentence of the first paragraph of the report illustrated in paragraph .04 should be modified as follows and paragraphs describing the material weaknesses should follow the first paragraph:

However, we noted the following matters involving internal control and its operation that we consider to be material weaknesses as defined above.

.06 In some cases reports on material weaknesses may include comments on specific aspects of internal control or on additional matters. For example, a regulatory agency may require comments on the accounting system and controls (but not on the control environment) or on compliance with certain provisions in contracts or regulations. In such cases the language in paragraph .04 should be modified to:

- a. identify clearly the specific aspects of internal controls or the additional matters covered by the report
- b. distinguish any additional matters from internal control

- c. describe in reasonable detail the scope of the review and tests concerning the additional matters
- d. express conclusions in language comparable to that in paragraph .04 or .05, as appropriate

.07 The identification of the specific aspects of internal control or additional matters covered in the report should be as specific as the auditor considers necessary to prevent misunderstanding in this respect. Such identification can be made in some cases by reference to specific portions of other documents such as contracts or regulations.

## **[2.] Audit Considerations for the Year 2000 Issue**

[.08-.17] [Paragraphs deleted.]

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# AI 13: Illegal Acts by Clients: Auditing Interpretations of AS 2405

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

View AS 2405, *Illegal Acts by Clients*

## Summary Table of Contents

**.01 Consideration of Internal Control in a Financial Statement Audit and the Foreign Corrupt Practices Act**

**.03 Material Weaknesses in Internal Control and the Foreign Corrupt Practices Act**

## 1. Consideration of Internal Control in a Financial Statement Audit and the Foreign Corrupt Practices Act

.01 *Question*—The auditing standards require the auditor to obtain a sufficient understanding of internal control to plan the audit and to determine the nature, timing, and extent of tests to be performed. Is the auditor of an entity subject to the Securities Exchange Act of 1934 required, because of the *Foreign Corrupt Practices Act of 1977* and the provisions of AS 2405, *Illegal Acts by Clients*, to expand his consideration of internal control beyond that which is required by AS 2110, *Identifying and Assessing Risks of Material Misstatement*?

.02 *Interpretation*—No. There is nothing in the Act or the related legislative history that purports to alter the auditor's duty to his client or the purpose of his consideration of internal control. The Act creates express new duties only for companies subject to the Securities Exchange Act of 1934, not for auditors.

## 2. Material Weaknesses in Internal Control and the Foreign Corrupt Practices Act

.03 *Question*—What course of action should be followed by the auditor of an entity subject to the internal accounting control provision of the *Foreign Corrupt Practices Act of 1977* to comply with AS 2405

when a material weakness in internal control comes to his attention?

.04 *Interpretation*—The standards applied by an auditor in determining a material weakness in internal control may differ from the standards for determining a violation of the Act. Nevertheless, a specific material weakness may ultimately be determined to be a violation and, hence, an illegal act. Therefore, the auditor should inquire of the client's management and consult with the client's legal counsel as to whether the material weakness is a violation of the Act.

.05 In consultation with management and legal counsel, consideration should be given to corrective action taken or in process. If management has concluded that corrective action for a material weakness is not practicable, consideration should be given to the reasons underlying that conclusion, including management's evaluation of the costs of correction in relation to the expected benefit to be derived.<sup>1</sup> If it is determined that there has been a violation of the Act and appropriate consideration is not given to the violation, the auditor should consider withdrawing from the current engagement or dissociating himself from any future relationship with the client (*see* AS 2405.22).

.06 A violation of the internal accounting control provision of the Act would not, in and of itself, have a direct effect on amounts presented in audited financial statements. However, the contingent monetary effect on an entity ultimately determined to have willfully violated the internal accounting control provision of the Act could be fines of up to \$10,000 for the violation. The auditor should consider the materiality of such contingent monetary effect in relation to the audited financial statements taken as a whole. Other loss contingencies, as defined by FASB Statement No. 5 [AC section C59], ordinarily would not result from a weakness in internal control which gives rise to such a violation of the Act.

### Footnotes (AI 13 - Illegal Acts by Clients: Auditing Interpretations of AS 2405):

<sup>1</sup> The legislative history of the Act indicates that cost-benefit considerations are appropriate in determining compliance with the accounting provisions of the Act. For example, the Senate committee report stated that "the size of the business, diversity of operations, degree of centralization of financial and operating management, amount of contact by top management with day-to-day operations, and numerous other circumstances are factors which management must consider in establishing and maintaining an internal accounting control system."

# AI 15: Consideration of an Entity's Ability to Continue as a Going Concern: Auditing Interpretations of AS 2415

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

View AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*

## 1. Eliminating a Going-Concern Explanatory Paragraph From a Reissued Report

.01 *Question*—An auditor may be asked to reissue his or her report on financial statements and eliminate the going-concern explanatory paragraph that appeared in the original report. Such requests ordinarily occur after the conditions that gave rise to substantial doubt about the entity's ability to continue as a going concern have been resolved. For example, subsequent to the date of the auditor's original report, an entity might obtain needed financing. In such circumstances, may the auditor reissue his or her report and eliminate the going-concern explanatory paragraph that appeared in the original report?

.02 *Interpretation*—An auditor has no obligation to reissue his or her report.<sup>1</sup> However, if the auditor decides to reissue the report,<sup>2</sup> the auditor should perform the following procedures when determining whether to reissue the report without the going-concern explanatory paragraph that appeared in the original report:

- Audit the event or transaction that prompted the request to reissue the report without the going-concern explanatory paragraph.
- Perform the procedures listed in paragraph .12 of AS 2801, *Subsequent Events*, at or near the date of reissuance.
- Consider the factors described in paragraphs .06 through .11 of AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*, based on the conditions and circumstances at the date of reissuance.

The auditor may perform any other procedures that he or she deems necessary in the circumstances. Based on the information that the auditor becomes aware of as a result of performing the procedures mentioned above, the auditor should reassess the going-concern status of the entity.

## **[2.] Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern**

[.03-.27] [Paragraphs deleted.]

### **Footnotes (AI 15 - Consideration of an Entity's Ability to Continue as a Going Concern: Auditing Interpretations of AS 2415):**

- <sup>1</sup> If the auditor decides not to reissue his or her report, the auditor may agree to be engaged to audit the financial statements for a period subsequent to that covered by the original report. This might be the case, for example, if the entity is experiencing profitable operations.
- <sup>2</sup> Paragraph .05 of AS 3110, *Dating of the Independent Auditor's Report*, states that an auditor may either "dual-date" or "later-date" his or her reissued report.

# AI 17: Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of AS 2505

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

View AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*

## Summary Table of Contents

- .01 Specifying Relevant Date in an Audit Inquiry Letter**
- .04 Relationship Between Date of Lawyer's Response and Auditor's Report**
- .06 Form of Audit Inquiry Letter When Client Represents That No Unasserted Claims and Assessments Exist**
- .08 Documents Subject to Lawyer-Client Privilege**
- .10 Alternative Wording of the Illustrative Audit Inquiry Letter to a Client's Lawyer**
- .15 Client Has Not Consulted a Lawyer**
- .18 Assessment of a Lawyer's Evaluation of the Outcome of Litigation**
- .24 Use of the Client's Inside Counsel in the Evaluation of Litigation, Claims, and Assessments**
- .28 Use of Explanatory Language About the Attorney-Client Privilege or the Attorney Work-Product Privilege**
- .31 Use of Explanatory Language Concerning Unasserted Possible Claims or Assessments in Lawyers' Responses to Audit Inquiry Letters**

## 1. Specifying Relevant Date in an Audit Inquiry Letter

.01 *Question*—Should the auditor request the client to specify, in his audit inquiry letter to a lawyer prepared in accordance with AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, the date by which the lawyer's response should be sent to the auditor. Also, should the letter request the lawyer to specify in his response the latest date covered by his review (the "effective date")?

.02 *Interpretation*—Yes. It should be recognized that, to adequately respond to an audit inquiry letter, lawyers will ordinarily employ some internal review procedures which will be facilitated by specifying the earliest acceptable effective date of the response and the latest date by which it should be sent to the auditor. Ordinarily, a two-week period should be allowed between the specified effective date of the lawyer's response and the latest date by which the response should be sent to the auditor. Clearly stating the relevant dates in the letter and specifying these dates to the lawyer in a timely manner will allow the responding lawyer an adequate amount of time to complete his review procedures and assist the auditor in coordinating the timing of the completion of his field work with the latest date covered by the lawyer's review.

.03 Further, the lawyer should be requested to specify the effective date of his response. If the lawyer's response does not specify an effective date, the auditor can assume that the date of the lawyer's response is the effective date.

## **2. Relationship Between Date of Lawyer's Response and Auditor's Report**

.04 *Question*—The illustrative form of audit inquiry letter included in the Appendix [AS 2505A] to AS 2505 requests a response as to matters that existed at the balance sheet date and during the period from that date to the date of the response. What is the relationship between the effective date of the lawyer's response and the date of the auditor's report?

.05 *Interpretation*—Paragraphs .10 through .12 of AS 2801, *Subsequent Events*, indicate that the auditor is concerned with events, which may require adjustment to, or disclosure in, the financial statements, occurring through the date of his or her report. Therefore, the latest date of the period covered by the lawyer's response (the "effective date") should be as close to the date of the auditor's report as is practicable in the circumstances. Consequently, specifying the effective date of the lawyer's response to reasonably approximate the expected date of the auditor's report will in most instances obviate the need for an updated response from the lawyer.

## **3. Form of Audit Inquiry Letter When Client Represents That No Unasserted Claims and Assessments Exist**

.06 *Question*—The illustrative audit inquiry letter included in the Appendix [AS 2505A] to AS 2505 assumes that the client specifies certain unasserted claims and assessments. However, in some cases, clients have stated that there are no such claims or assessments (to be specified to the lawyer for comment) that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome. What appropriate revision to the wording of the letter can be used in such situations?

.07 *Interpretation*—Wording that could be used in an audit inquiry letter, instead of the heading and

first paragraph in the section relating to unasserted claims and assessments included in the Appendix [AS 2505A] to AS 2505, when the client believes that there are no unasserted claims or assessments (to be specified to the lawyer for comment) that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome as specified by FASB Statement No. 5, *Accounting for Contingencies* [AC section C59], is as follows:

*Unasserted claims and assessments*—We have represented to our auditors that there are no unasserted possible claims that you have advised us are probable of assertion and must be disclosed, in accordance with Statement of Financial Accounting Standards No. 5. (The second paragraph in the section relating to unasserted claims and assessments would not be altered.)

#### 4. Documents Subject to Lawyer-Client Privilege

.08 *Question*—AS 2505.05c, states: "Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers." Would this include a review of documents at the client's location considered by the lawyer and the client to be subject to the lawyer-client privilege?

.09 *Interpretation*—No. Although ordinarily an auditor would consider the inability to review information that could have a significant bearing on his audit as a scope restriction, in recognition of the public interest in protecting the confidentiality of lawyer-client communications (*see* AS 2505.13), AS 2505.05c is not intended to require an auditor to examine documents that the client identifies as subject to the lawyer-client privilege. In the event of questions concerning the applicability of this privilege, the auditor may request confirmation from the client's counsel that the information is subject to that privilege and that the information was considered by the lawyer in responding to the audit inquiry letter or, if the matters are being handled by another lawyer, an identification of such lawyer for the purpose of sending him an audit inquiry letter.

#### 5. Alternative Wording of the Illustrative Audit Inquiry Letter to a Client's Lawyer

.10 *Question*—The Appendix [AS 2505A] of AS 2505 provides an illustrative audit inquiry letter to legal counsel. That inquiry letter is based on the assumptions that (1) management of the company has prepared and furnished to the auditor and has set forth in the audit inquiry letter a description and evaluation of pending or threatened litigation, claims, and assessments and (2) management has identified and specified for comment in the audit inquiry letter unasserted claims or assessments that are probable of assertion and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome. In many engagements, circumstances may render certain portions of the illustrative letter inappropriate. For instance, many clients ask their lawyers to prepare the list that describes and evaluates pending or threatened litigation, claims, and assessments rather than have management furnish such information. How can the wording of the inquiry letter be modified to recognize circumstances that differ from those assumed in the illustrative letter and to be more specific regarding the timing of the lawyer's response?

.11 *Interpretation*—AS 2505.09, outlines the matters that should be covered in a letter of audit inquiry. Although AS 2505 provides an illustrative audit inquiry letter to legal counsel, it should be modified, if

necessary, to fit the circumstances. The modified illustrative audit inquiry letter that follows is based on a typical situation: management requests the lawyer to prepare the list that describes and evaluates pending or threatened litigation, claims, and assessments, and also represents that there are no unasserted claims or assessments that are probable of assertion and that, if asserted, would have a reasonable possibility of an unfavorable outcome as specified by FASB Statement No. 5, *Accounting for Contingencies* [AC section C59]. It also includes a separate response section with language that clarifies the auditor's expectations regarding the timing of the lawyer's response.

"In connection with an audit of our financial statements as of (balance-sheet date) and for the (period) then ended, please furnish our auditors, (name and address of auditors), with the information requested below concerning certain contingencies involving matters with respect to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation." [When a materiality limit has been established based on an understanding between management and the auditor, the following sentence should be added: This request is limited to contingencies amounting to (amount) individually or items involving lesser amounts that exceed (amount) in the aggregate.]

**.12 Pending or Threatened Litigation, Claims, and Assessments**

"Regarding pending or threatened litigation, claims, and assessments, please include in your response: (1) the nature of each matter, (2) the progress of each matter to date, (3) how the Company is responding or intends to respond (for example, to contest the case vigorously or seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss."

**.13 Unasserted Claims and Assessments**

"We have represented to our auditors that there are no unasserted possible claims or assessments that you have advised us are probable of assertion and must be disclosed in accordance with FASB Statement No. 5 [AC section C59].<sup>1</sup> We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of FASB Statement No. 5 [AC section C59]. Please specifically confirm to our auditors that our understanding is correct."

**.14 Response**

"Your response should include matters that existed as of (balance-sheet date) and during the period from that date to the effective date of your response."

"Please specifically identify the nature of and reasons for any limitations on your



response."

"Our auditors expect to have the audit completed about (expected completion date). They would appreciate receiving your reply by that date with a specified effective date no earlier than (ordinarily two weeks before expected completion date)."<sup>2</sup>

## 6. Client Has Not Consulted a Lawyer

.15 *Question*—AS 2505.06 requires an auditor to request that the client's management send a letter of inquiry to those lawyers with whom management has consulted concerning litigation, claims, or assessments. In some instances, management may not have consulted a lawyer. In such circumstances, what should the auditor do to obtain sufficient, competent evidential matter regarding litigation, claims, and assessments?

.16 *Interpretation*—AS 2505 is expressly limited to inquiry of lawyers with whom management has consulted. If the client has not consulted a lawyer, the auditor normally would rely on the review of internally available information as outlined in AS 2505.05 and .07, and the written representation of management regarding litigation, claims, and assessments as required by paragraphs .06o and p of AS 2805, *Management Representations*. In those circumstances, the representation regarding litigation, claims, and assessments might be worded as follows:

"We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with FASB Statement No. 5 [AC section C59], and we have not consulted a lawyer concerning litigation, claims, or assessments."

.17 If information comes to the auditor's attention that may indicate potentially material litigation, claims, and assessments, the auditor should discuss with the client its possible need to consult legal counsel so that the client may evaluate its responsibility under FASB Statement No. 5 [AC section C59] to accrue or disclose loss contingencies. Depending on the severity of the matter, refusal by the client to consult legal counsel in those circumstances may result in a scope limitation, and the auditor should consider the effect of such a limitation on his audit report.

## 7. Assessment of a Lawyer's Evaluation of the Outcome of Litigation

.18 *Question*—AS 2505.09d(2), states that a letter of audit inquiry should include a request for the lawyer's evaluation of the likelihood of an unfavorable outcome of pending or threatened litigation, claims, and assessments to which he has devoted substantive attention. However, written responses from lawyers vary considerably and may contain evaluation wording that is vague or ambiguous and, thus, of limited use to the auditor. What constitutes a clear response and what should the auditor do if he considers the response unclear?

.19 *Interpretation*—The American Bar Association's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* (ABA Statement) is reprinted as Exhibit II [AS 2505C] to AS 2505. While Paragraph 5 of the ABA Statement [AS 2505C] states that the lawyer "may in appropriate

circumstances communicate to the auditor his view that an unfavorable outcome is 'probable' or 'remote'," he is not required to use those terms in communicating his evaluation to the auditor. The auditor may find other wording sufficiently clear as long as the terms can be used to classify the outcome of the uncertainty under one of the three probability classifications established in FASB Statement No. 5, *Accounting for Contingencies* [AC section C59].<sup>3</sup>

.20 Some examples of evaluations concerning litigation that may be considered to provide sufficient clarity that the likelihood of an unfavorable outcome is "remote" even though they do not use that term are:

- "We are of the opinion that this action will not result in any liability to the company."
- "It is our opinion that the possible liability to the company in this proceeding is nominal in amount."
- "We believe the company will be able to defend this action successfully."
- "We believe that the plaintiff's case against the company is without merit."
- "Based on the facts known to us, after a full investigation, it is our opinion that no liability will be established against the company in these suits."

.21 Absent any contradictory information obtained by the auditor either in other parts of the lawyer's letter or otherwise, the auditor need not obtain further clarification of evaluations such as the foregoing.

.22 Because of inherent uncertainties described in AS 2505.14 and in the ABA Policy Statement [AS 2505C], an evaluation furnished by the lawyer may indicate significant uncertainties or stipulations as to whether the client will prevail. The following are examples of lawyers' evaluations that are unclear as to the likelihood of an unfavorable outcome:

- "This action involves unique characteristics wherein authoritative legal precedents do not seem to exist. We believe that the plaintiff will have serious problems establishing the company's liability under the act; nevertheless, if the plaintiff is successful, the award may be substantial."
- "It is our opinion that the company will be able to assert meritorious defenses to this action." (The term "meritorious defenses" indicates that the company's defenses will not be summarily dismissed by the court; it does not necessarily indicate counsel's opinion that the company will prevail.)
- "We believe the action can be settled for less than the damages claimed."
- "We are unable to express an opinion as to the merits of the litigation at this time. The company believes there is absolutely no merit to the litigation." (If client's counsel, with the benefit of all relevant information, is unable to conclude that the likelihood of an unfavorable outcome is "remote," it is unlikely that management would be able to form a judgment to that effect.)
- "In our opinion, the company has a substantial chance of prevailing in this action." (A "substantial chance," a "reasonable opportunity," and similar terms indicate more uncertainty than an opinion

that the company will prevail.)

.23 If the auditor is uncertain as to the meaning of the lawyer's evaluation, he should request clarification either in a follow-up letter or a conference with the lawyer and client, appropriately documented. If the lawyer is still unable to give an unequivocal evaluation of the likelihood of an unfavorable outcome in writing or orally, the auditor should look to the guidance in paragraphs .28 through .32 of AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, to determine the effect, if any, of the lawyer's response on the auditor's report.

## **8. Use of the Client's Inside Counsel in the Evaluation of Litigation, Claims, and Assessments**

.24 *Question*—AS 2505.06 requires an auditor to request that the client's management send a letter of inquiry to those lawyers with whom management has consulted concerning litigation, claims, and assessments. Sometimes, the client's inside general counsel or legal department (hereinafter referred to as "inside counsel") is handling litigation, claims, and assessments either exclusive of or in conjunction with outside lawyers. In such circumstances, when does inside counsel's response constitute sufficient, competent evidential matter regarding litigation, claims, and assessments?

.25 *Interpretation*—AS 2505.08 states that "Evidential matter obtained from the client's inside general counsel or legal department may provide the auditor with the necessary corroboration." Inside counsel can range from one lawyer to a large staff, with responsibilities ranging from specific internal matters to a comprehensive coverage of all of the client's legal needs, including litigation with outside parties. Because both inside counsel and outside lawyers are bound by the ABA's Code of Professional Responsibilities, there is no difference in their professional obligations and responsibilities. In some circumstances, outside lawyers, if used at all, may be used only for limited purposes, such as data accumulation or account collection activity. In such circumstances, inside counsel has the primary responsibility for corporate legal matters and is in the best position to know and precisely describe the status of all litigation, claims, and assessments or to corroborate information furnished by management.

.26 Audit inquiry letters should be sent to those lawyers, which may be either inside counsel or outside lawyers, who have the primary responsibility for, and knowledge about, particular litigation, claims, and assessments. If inside counsel is handling litigation, claims, and assessments exclusively, their evaluation and response ordinarily would be considered adequate. Similarly, if both inside counsel and outside lawyers have been involved in the matters, but inside counsel has assumed the primary responsibility for the matters, inside counsel's evaluation may well be considered adequate.<sup>4</sup> However, there may be circumstances when litigation, claims, or assessments involving substantial overall participation by outside lawyers are of such significance to the financial statements that the auditor should consider obtaining the outside lawyers' response that they have not formulated a substantive conclusion that differs in any material respect from inside counsel's evaluation, even though inside counsel may have primary responsibility.

.27 If both inside counsel and outside lawyers have devoted substantive attention to a legal matter, but their evaluations of the possible outcome differ, the auditor should discuss the differences with the

parties involved. Failure to reach agreement between the lawyers may require the auditor to consider appropriate modification of his audit report.

## 9. Use of Explanatory Language About the Attorney-Client Privilege or the Attorney Work-Product Privilege

.28 *Question*—In some cases, in order to emphasize the preservation of the attorney-client privilege or the attorney work-product privilege, some clients have included the following or substantially similar language in the audit inquiry letter to legal counsel:

We do not intend that either our request to you to provide information to our auditor or your response to our auditor should be construed in any way to constitute a waiver of the attorney-client privilege or the attorney work-product privilege.

For the same reason, some lawyers have included the following or substantially similar language in their response letters to auditors:

The Company [OR OTHER DEFINED TERM] has advised us that, by making the request set forth in its letter to us, the Company [OR OTHER DEFINED TERM] does not intend to waive the attorney-client privilege with respect to any information which the Company [OR OTHER DEFINED TERM] has furnished to us. Moreover, please be advised that our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege with respect to any of our files involving the Company [OR OTHER DEFINED TERM].

Does the explanatory language about the attorney-client privilege or the attorney work-product privilege result in a limitation on the scope of the audit?

.29 *Answer*—No. According to the *Report by the American Bar Association's Subcommittee on Audit Inquiry Responses*, explanatory language similar to the foregoing in the letters of the client or the lawyer is not a limitation on the scope of the lawyer's response. The report states that such language simply makes explicit what has always been implicit, namely, the language states clearly that neither the client nor the lawyer intended a waiver. The report further states that non-inclusion of either or both of the foregoing statements by the client or the lawyer in their respective letters at any time in the past or the future would not constitute an expression of intent to waive the privileges. The *Report by the American Bar Association's Subcommittee on Audit Inquiry Responses* is reprinted in paragraph .30.

### .30 **Report of the Subcommittee on Audit Inquiry Responses**\*

Because of a recent court case and other judicial decisions involving lawyers' responses to auditors' requests for information, an area of uncertainty or concern has been brought to the Subcommittee's attention and is the subject of the following comment:

This Committee's report does not modify the ABA Statement of Policy, nor does it constitute an interpretation thereof. The Preamble to the ABA Statement of Policy states as follows:

Both the Code of Professional Responsibility and the cases applying the evidentiary privilege recognize that the privilege against disclosure can be knowingly and voluntarily waived by the client. It is equally clear that disclosure to a third party may result in loss of the "confidentiality" essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client's ability in other contexts to maintain the confidentiality of such communications.

Under the circumstances a policy of audit procedure which requires clients to give consent and authorize lawyers to respond to general inquiries and disclose information to auditors concerning matters which have been communicated in confidence is essentially destructive of free and open communication and early consultation between lawyer and client. The institution of such a policy would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might become public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.

It is also recognized that our legal, political, and economic systems depend to an important extent on public confidence in published financial statements. To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence. On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between lawyer and client, thereby strengthening corporate management's confidence in counsel and to act in accordance with counsel's advice.

Paragraph (1) of the ABA Statement of Policy provides as follows:

- (1) *Client Consent to Response.* The lawyer may properly respond to the auditor's requests for information concerning loss contingencies (the term and concept established by Statement of Financial Accounting Standards No. 5, promulgated by the Financial Accounting Standards Board in March 1975 and discussed in Paragraph 5.1 of the accompanying commentary), to the extent hereinafter set forth, subject to the following:
  - (a) Assuming that the client's initial letter requesting the lawyer to provide information to the auditor is signed by an agent of the client having apparent authority to make such a request, the lawyer may provide to the auditor information requested, without further consent, unless such information discloses a confidence or a secret or requires an evaluation of a claim.
  - (b) In the normal case, the initial request letter does not provide the necessary consent to the disclosure of a confidence or secret or to the evaluation of a claim since that consent may only be given after full disclosure to the client of the legal

consequences of such action.

- (c) Lawyers should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission.
- (d) In securing the client's consent to the disclosure of confidences or secrets, or the evaluation of claims, the lawyer may wish to have a draft of his letter reviewed and approved by the client before releasing it to the auditor; in such cases, additional explanation would in all probability be necessary so that the legal consequences of the consent are fully disclosed to the client.

In order to preserve explicitly the evidentiary privileges, some lawyers have suggested that clients include language in the following or substantially similar form:

We do not intend that either our request to you to provide information to our auditor or your response to our auditor should be construed in any way to constitute a waiver of the attorney-client privilege or the attorney work-product privilege.

If client's request letter does not contain language similar to that in the preceding paragraph, the lawyer's statement that the client has so advised him or her may be based upon the fact that the client has in fact so advised the lawyer, in writing or orally, in other communications or in discussions.

For the same reason, the response letter from some lawyers also includes language in the following or substantially similar form:

The Company [OR OTHER DEFINED TERM] has advised us that, by making the request set forth in its letter to us, the Company [OR OTHER DEFINED TERM] does not intend to waive the attorney-client privilege with respect to any information which the Company [OR OTHER DEFINED TERM] has furnished to us. Moreover, please be advised that our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege with respect to any of our files involving the Company [OR OTHER DEFINED TERM].

We believe that language similar to the foregoing in letters of the client or the lawyer simply makes explicit what has always been implicit, namely, it expressly states clearly that neither the client nor the lawyer intended a waiver. It follows that non-inclusion of either or both of the foregoing statements by the client or the lawyer in their respective letters at any time in the past or the future would not constitute an expression of intent to waive the privileges.

On the other hand, the inclusion of such language does not necessarily assure the client that, depending on the facts and circumstances, a waiver may not be found by a court of law to have occurred.

We do not believe that the foregoing types of inclusions cause a negative impact upon the public policy considerations described in the Preamble to the ABA Statement of Policy nor do they intrude upon the arrangements between the legal profession and the accounting profession contemplated by the ABA Statement of Policy. Moreover, we do not believe that such language interferes in any way with the

standards and procedures of the accounting profession in the auditing process nor should it be construed as a limitation upon the lawyer's reply to the auditors. We have been informed that the Auditing Standards Board of the AICPA has adopted an interpretation of SAS 12 recognizing the propriety of these statements.

Lawyers, in any case, should be encouraged to have their draft letters to auditors reviewed and approved by the client before releasing them to the auditors and may wish to explain to the client the legal consequences of the client's consent to lawyer's response as contemplated by subparagraph 1(d) of the Statement of Policy.

December 1989

## 10. Use of Explanatory Language Concerning Unasserted Possible Claims or Assessments in Lawyers' Responses to Audit Inquiry Letters

.31 *Question*—In order to emphasize the preservation of the attorney-client privilege with respect to unasserted possible claims or assessments, some lawyers include the following or substantially similar language in their responses to audit inquiry letters:

"Please be advised that pursuant to clauses (b) and (c) of Paragraph 5 of the ABA Statement of Policy [American Bar Association's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*] 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."

Does the inclusion of this or similar language result in a limitation on the scope of the audit?

.32 *Interpretation*—No. Additional language similar to the foregoing in a letter of a lawyer is not a limitation on the scope of the audit. However, the ABA Statement of Policy [AS 2505C] and the understanding between the legal and accounting professions assumes 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 possible claims or assessments.<sup>5</sup> Confirmation of this understanding should be included in the lawyer's response.

### Footnotes (AI 17 - Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of AS 2505):

<sup>1</sup> A parenthetical statement such as "(excerpts of which can be found in the ABA's *Auditor's Letter Handbook*)" might be added here if the auditor believes that it would be helpful to the lawyer's

understanding of the requirements of FASB Statement No. 5 [AC section C59]. *The Auditor's Letter Handbook* contains, among other things, a copy of AS 2505, the ABA's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* [AS 2505C], and excerpts from FASB Statement No. 5 [AC section C59].

<sup>2</sup> Two auditing interpretations (*see* paragraphs .01-.05) address relevant dates in an audit inquiry letter and the relationship between the date of the lawyer's response and the audit report date.

<sup>3</sup> FASB Statement No. 5 [AC section C59] uses the terms "probable," "reasonably possible," and "remote" to describe different degrees of likelihood that future events will confirm a loss or an impairment of an asset or incurrence of a liability, and the accounting standards for accrual and disclosure are based on those terms.

<sup>4</sup> This does not alter the caveat in AS 2505.08 that "evidential matter obtained from inside counsel is not a substitute for information outside counsel refuses to furnish."

\* "Excerpted from 'Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information,' *The Business Lawyer*, vol. 31, no. 3, April 1976, copyright 1976 American Bar Association, reprinted by permission of the American Bar Association."

<sup>5</sup> *See* Paragraph 6 of the ABA Statement of Policy [AS 2505C] and its Commentary [AS 2505C]. In addition, Annex A to the ABA Statement of Policy [AS 2505C] contains the following illustrative language in the lawyers' response letter to the auditors: "Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in its audit inquiry letter to us that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of FASB Statement No. 5, *Accounting for Contingencies* [AC section C59]."



# AI 18: Consideration of an Entity's Use of a Service Organization: Auditing Interpretations of AS 2601

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

View AS 2601, *Consideration of an Entity's Use of a Service Organization*

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**.01 Describing Tests of Operating Effectiveness and the Results of Such Tests**

**.04 Service Organizations That Use the Services of Other Service Organizations (Subservice Organizations)**

**.35 Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls**

**.38 Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods**

## **1. Describing Tests of Operating Effectiveness and the Results of Such Tests**

.01 *Question*—Paragraph .44f of AS 2601, *Consideration of an Entity's Use of a Service Organization*, specifies the elements that should be included in a description of tests of operating effectiveness, which is part of a report on controls placed in operation and tests of operating effectiveness. AS 2601.44f states:

" . . . 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. The description should include an indication of the nature, timing, and extent of the 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 the service auditor identified causative factors for exceptions, determined the current status of corrective actions, or obtained other relevant qualitative information about exceptions noted, such information should be provided."

When a service auditor performs an engagement that includes tests of operating effectiveness, what

information and how much detail should be included in the description of the "tests applied" and the "results of the tests"?

.02 *Interpretation*—In all cases, for each control objective tested, the description of tests of operating effectiveness should include all of the elements listed in AS 2601.44f, whether or not the service auditor concludes that the control objective has been achieved. The description should provide sufficient information to enable user auditors to assess control risk for financial statement assertions affected by the service organization. The description need not be a duplication of the service auditor's detailed audit program, which in some cases would make the report too voluminous for user auditors and would provide more than the required level of detail.

.03 In describing the nature, timing, and extent of the tests applied, the service auditor also should indicate whether the items tested represent a sample or all of the items in the population, but need not indicate the size of the population. In describing the results of the tests, the service auditor should include exceptions and other information that in the service auditor's judgment could be relevant to user auditors. Such exceptions and other information should be included for each control objective, whether or not the service auditor concludes that the control objective has been achieved. When exceptions that could be relevant to user auditors are noted, the description also should include the following information:

- The size of the sample, when sampling has been used
- The number of exceptions noted
- The nature of the exceptions

If no exceptions or other information that could be relevant to user auditors are identified by the tests, the service auditor should indicate that finding (for example, "No relevant exceptions noted").

## **2. Service Organizations That Use the Services of Other Service Organizations (Subservice Organizations)**

.04 *Question*—A service organization may use the services of another service organization, such as a bank trust department that uses an independent computer processing service organization to perform its data processing. In this situation, the bank trust department is a service organization and the computer processing service organization is considered a subservice organization. How are a user auditor's and a service auditor's procedures affected when a service organization uses a subservice organization?

.05 *Interpretation*—When a service organization uses a subservice organization, the user auditor should determine whether the processing performed by the subservice organization affects assertions in the user organization's financial statements and whether those assertions are significant to the user organization's financial statements. To plan the audit and assess control risk, a user auditor may need to consider the controls at both the service organization and the subservice organization. AS 2601.06 through .17 provide guidance to user auditors on considering the effect of a service organization on a user organization's internal control. Although AS 2601.06-.17 do not specifically refer to subservice organizations, when a subservice organization provides services to a service organization, the guidance in

these paragraphs should be interpreted to include the subservice organization. For example, in situations where subservice organizations are used, the interaction between the user organization and the service organization described in AS 2601.06 would be expanded to include the interaction between the user organization, the service organization and the subservice organization.

.06 Similarly, a service auditor engaged to examine the controls of a service organization and issue a service auditor's report may need to consider functions performed by the subservice organization and the effect of the subservice organization's controls on the service organization.

.07 The degree of interaction and the nature and materiality of the transactions processed by the service organization and the subservice organization are the most important factors to consider in determining the significance of the subservice organization's controls to the user organization's internal control. AS 2601.11-.16 describe how a user auditor's assessment of control risk is affected when a user organization uses a service organization. When a subservice organization is involved, the user auditor may need to consider activities at both the service organization and the subservice organization in applying the guidance in these paragraphs.

.08 *Question*—How does a user auditor obtain information about controls at a subservice organization?

.09 *Interpretation*—If a user auditor concludes that he or she needs information about the subservice organization to plan the audit or to assess control risk, the user auditor (a) may contact the service organization through the user organization and may contact the subservice organization either through the user organization or the service organization to obtain specific information or (b) may request that a service auditor be engaged to perform procedures that will supply the necessary information. Alternatively, the user auditor may visit the service organization or subservice organization and perform such procedures.

.10 *Question*—When a service organization uses a subservice organization, what information about the subservice organization should be included in the service organization's description of controls?

.11 *Interpretation*—A service organization's description of controls should include a description of the functions and nature of the processing performed by the subservice organization in sufficient detail for user auditors to understand the significance of the subservice organization's functions to the processing of the user organizations' transactions. Ordinarily, disclosure of the identity of the subservice organization is not required. However, if the service organization determines that the identity of the subservice organization would be relevant to user organizations, the name of the subservice organization may be included in the description. The purpose of the description of the functions and nature of the processing performed by the subservice organization is to alert user organizations and their auditors to the fact that another entity (that is, the subservice organization) is involved in the processing of the user organizations' transactions and to summarize the functions the subservice organization performs.

.12 When a subservice organization performs services for a service organization, there are two alternative methods of presenting the description of controls. The service organization determines which method will be used.

- a. *The Carve-Out Method*—The subservice organization's relevant control objectives and controls are excluded from the description and from the scope of the service auditor's engagement. The service organization states in the description that the subservice organization's control objectives and related controls are omitted from the description and that the control objectives in the report include only the objectives the service organization's controls are intended to achieve.
- b. *The Inclusive Method*—The subservice organization's relevant controls are included in the description and in the scope of the engagement. The description should clearly differentiate between controls of the service organization and controls of the subservice organization. The set of control objectives includes all of the objectives a user auditor would expect both the service organization and the subservice organization to achieve. To accomplish this, the service organization should coordinate the preparation and presentation of the description of controls with the subservice organization.

In either method, the service organization includes in its description of controls a description of the functions and nature of the processing performed by the subservice organization, as set forth in paragraph .11.

.13 If the functions and processing performed by the subservice organization are significant to the processing of user organization transactions, and the service organization does not disclose the existence of the subservice organization and the functions it performs, the service auditor may need to issue a qualified or adverse opinion as to the fairness of the presentation of the description of controls.

.14 *Question*—How is the service auditor's report affected by the method of presentation selected?

.15 *Interpretation*—If the service organization has adopted the carve-out method, the service auditor should modify the scope paragraph of the service auditor's report to briefly summarize the functions and nature of the processing performed by the subservice organization. This summary ordinarily would be briefer than the information provided by the service organization in its description of the functions and nature of the processing performed by the subservice organization. The service auditor should include a statement in the scope paragraph of the service auditor's report indicating that the description of controls includes only the control objectives and related controls of the service organization; accordingly, the service auditor's examination does not extend to controls at the subservice organization.

.16 An example of the scope paragraph of a service auditor's report using the carve-out method is presented below. Additional or modified report language is shown in ***boldface italics***.

### ***Sample Scope Paragraph of a Service Auditor's Report Using the Carve-Out Method***

#### Service Auditor's Report of Independent Registered Public Accounting Firm

To the Board of Directors of Example Trust Company:

We have examined the accompanying description of the controls of Example Trust Company

applicable to the processing of transactions for users of the Institutional Trust Division. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of Example Trust Company'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 user organizations applied the controls contemplated in the design of Example Trust Company's controls; and (3) such controls had been placed in operation as of June 30, 20XX.

**Example Trust Company uses a computer processing service organization for all of its computerized application processing. The accompanying description includes only those control objectives and related controls of Example Trust Company and does not include control objectives and related controls of the computer processing service organization. Our examination did not extend to controls of the computer processing service organization.** The control objectives were specified by the management of Example Trust Company. Our examination was performed in accordance with the standards of the Public Company Accounting Oversight Board (United States) and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

[The remainder of the report is the same as the standard service auditor's report illustrated in AS 2601.38 and .54.]

.17 If the service organization has used the inclusive method, the service auditor should perform procedures comparable to those described in AS 2601.12. Such procedures may include performing tests of the service organization's controls over the activities of the subservice organization or performing procedures at the subservice organization. If the service auditor will be performing procedures at the subservice organization, the service organization should arrange for such procedures. The service auditor should recognize that the subservice organization generally is not the client for the engagement. Accordingly, in these circumstances the service auditor should determine whether it will be possible to obtain the required evidence to support the portion of the opinion covering the subservice organization and whether it will be possible to obtain an appropriate letter of representations regarding the subservice organization's controls.

.18 An example of a service auditor's report using the inclusive method is presented below. Additional or modified report language is shown in **boldface italics**.

## **Sample Service Auditor's Report Using the Inclusive Method**

### Service Auditor's Report of Independent Registered Public Accounting Firm

To the Board of Directors of Example Trust Company:

We have examined the accompanying description of the controls of Example Trust Company **and Computer Processing Service Organization, an independent service organization that provides computer processing services to Example Trust Company**, applicable to the processing of

transactions for users of the Institutional Trust Division. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of Example Trust Company's **and Computer Processing 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 user organizations applied the controls contemplated in the design of Example Trust Company's controls; and (3) the controls had been placed in operation as of June 30, 20XX. The control objectives were specified by the management of Example Trust Company. Our examination was performed in accordance with the standards of the Public Company Accounting Oversight Board (United States) 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 controls presents fairly, in all material respects, the relevant aspects of Example Trust Company's **and Computer Processing Service Organization's** controls that had been placed in operation as of June 30, 20XX. 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 and user organizations applied the controls contemplated in the design of Example Trust Company's controls.

In addition to the procedures we considered necessary to render our opinion as expressed in the previous paragraph, we applied tests to specific controls, listed in Schedule X to obtain evidence about their effectiveness in meeting the control objectives, described in Schedule X, during the period from January 1, 20XX, to June 30, 20XX. 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 Example Trust Company and to their auditors to be taken into consideration, along with information about 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 January 1, 20XX, to June 30, 20XX.

The relative effectiveness and significance of specific controls at Example Trust Company **and Computer Processing Service Organization**, and their effect on assessments of control risk at user organizations are dependent on their interaction with the controls and other factors present at individual user organizations. We have performed no procedures to evaluate the effectiveness of controls at individual user organizations.

The description of controls at Example Trust Company **and Computer Processing Service Organization** is as of June 30, 20XX, and information about tests of the operating effectiveness of specific controls covers the period from January 1, 20XX, to June 30, 20XX. 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 **and Computer Processing 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.<sup>1</sup>

This report is intended solely for use by the management of Example Trust Company, its users, and the independent auditors of its users.

July 10, 20XX

### **[3.] Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls**

[.19-.34] [Paragraphs deleted.]

### **4. Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls**

.35 *Question*—AS 2601.32 requires a service auditor to consider "whether any other information, irrespective of specified control objectives, has come to his or her attention that causes him or her to conclude (a) that design deficiencies exist that could adversely affect the ability to initiate, record, process, or report financial data to user organizations without error, and (b) that user organizations would not generally be expected to have controls in place to mitigate such design deficiencies." A service auditor performing a service auditor's engagement may become aware that a service organization, whose system is correctly processing data during the period covered by the service auditor's examination, has not performed contingency planning or made adequate provision for disaster recovery, and may not be able to retrieve or process data in future periods. Does AS 2601.32 require a service auditor to identify, in his or her report, design deficiencies that do not affect processing during the period covered by the service auditor's examination but may represent potential problems in future periods?

.36 *Interpretation*—No. AS 2601.32 addresses design deficiencies that could adversely affect processing *during the period covered by the service auditor's examination*. AS 2601.32 does not apply to design deficiencies that potentially could affect processing *in future periods*. If the computer programs are correctly processing data during the period covered by the service auditor's examination, and such design deficiencies currently do not affect user organizations' abilities to initiate, record, process, or report financial data, the service auditor would not be required to report such design deficiencies in his or her report, based on the requirements in AS 2601.32. However, if a service auditor becomes aware of design deficiencies at the service organization that could potentially affect the processing of user organizations' transactions in future periods, the service auditor, in his or her judgment, may choose to communicate this information to the service organization's management and advise management to disclose this information and its plans for correcting the design deficiencies in a section of the service auditor's document titled "Other Information Provided by the Service Organization."

.37 If the service organization includes information about the design deficiencies in the section of the document titled "Other Information Provided by the Service Organization," the service auditor should read the information and consider applying by analogy the guidance in AS 2710, *Other Information in Documents Containing Audited Financial Statements*. In addition, the service auditor should include a paragraph in his or her report disclaiming an opinion on the information provided by the service organization. The following is an example of such a paragraph.

The information in section 4 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.

A service auditor also may consider communicating information about the design deficiencies in the section of the service auditor's document titled "Other Information Provided by the Service Auditor."

## 5. Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods

.38 *Question*—AS 2601.29g and .44l state that a service auditor's 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. AS 2601.44l goes on to state that the report also should refer to the risk of projecting to the future "any conclusions about the effectiveness of controls in achieving control objectives." The sample service auditor's reports in AS 2601.38 and .54 include illustrative paragraphs that illustrate this caveat. The following excerpt is from AS 2601.54:

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

The validity of projections to the future about the effectiveness of controls may be affected by changes made to the system and the controls, and also by the failure to make needed changes, for example, changes to accommodate new processing requirements. May a service auditor's report be expanded to describe the risk of projecting to the future conclusions about the effectiveness of controls?

.39 *Interpretation*—The sample reports in AS 2601.38 and .54 may be expanded to describe this risk. The first and second sentences of the illustrative paragraph above address the potential effect of change on the description of controls as of a specified date; accordingly, they do not require modification because



new processing requirements would not affect the description as of the specified date. However, the last sentence in the sample report paragraph above could be expanded to describe the risk of projecting an evaluation of the controls to future periods because of changes to the system or controls, or the failure to make needed changes to the system or controls.

.40 Suggested additions to the paragraph in the illustrative service auditor's reports in AS 2601.38 and .54 are the following (new language is shown in italics.):

The description of controls at XYZ Service Organization is as of \_\_\_\_\_, and information about tests of the operating effectiveness of specific controls covers the period from \_\_\_\_\_ to \_\_\_\_\_. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes *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.

## **[6.] Responsibilities of Service Organizations and Service Auditors With Respect to Subsequent Events in a Service Auditor's Engagement**

.41 [Paragraph deleted.]

### **Footnotes (AI 18 - Consideration of an Entity's Use of a Service Organization: Auditing Interpretations of AS 2601):**

<sup>1</sup> This sentence has been expanded to describe the risks of projecting any evaluation of the controls to future periods because of the failure to make needed changes to a system or controls, as provided for in Interpretation No. 5, "Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods" (paragraphs .38-.40).

## AI 19: Required Supplementary Information: Auditing Interpretations of AS 2705

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

View AS 2705, *Required Supplementary Information*

### 1. Supplementary Oil and Gas Reserve Information

.01 *Question*—FASB Statement No. 69, *Disclosures About Oil and Gas Producing Activities* [AC section Oi5], which amended FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies* [AC section Oi5], and FASB Statement No. 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies* [AC section Oi5], requires publicly traded entities that have significant oil and gas producing activities to include, with complete sets of annual financial statements, disclosures of proved oil and gas reserve quantities, changes in reserve quantities, a standardized measure of discounted future net cash flows relating to reserve quantities, and changes in the standardized measure. In documents filed with the Securities and Exchange Commission (SEC), Regulation S-K requires that the disclosures related to annual periods be presented for each annual period for which an income statement is required and the disclosures as of the end of an annual period be presented as of the date of each audited balance sheet required. These disclosures are considered to be supplementary information and may be presented outside the basic financial statements. In these circumstances, should the auditor consider the provisions of AS 2705, *Required Supplementary Information*?

.02 *Interpretation*—Yes. Also, in addition to the provisions of AS 2705, the auditor should also consider the provisions of this Interpretation.

.03 Estimating oil and gas reserves is a complex process requiring the knowledge and experience of a reservoir engineer. In general, the quality of the estimate of proved reserves for an individual reservoir depends on the availability, completeness, and accuracy of data needed to develop the estimate and on the experience and judgment of the reservoir engineer. Estimates of proved reserves inevitably change over time as additional data become available and are taken into account. The magnitude of changes in these estimates is often substantial. Because oil and gas reserve estimates are more imprecise than most estimates that are made in preparing financial statements, entities are encouraged to explain the

imprecise nature of such reserve estimates.

.04 In applying the procedures specified in AS 2705, the auditor's inquiries should be directed to management's understanding of the specific requirements for disclosure of the supplementary oil and gas reserve information, including—

- a. The factors considered in determining the reserve quantity information to be reported, such as including in the information (1) quantities of all domestic and foreign proved oil and gas reserves owned by the entity net of interests of others, (2) reserves attributable to consolidated subsidiaries, (3) a proportionate share of reserves of investees that are proportionately consolidated, and (4) reserves relating to royalty interests owned.
- b. The separate disclosure of items such as (1) the entity's share of oil and gas produced from royalty interests for which reserve quantity information is unavailable, (2) reserves subject to long-term agreements with governments or authorities in which the entity participates in the operation or otherwise serves as producer, (3) the entity's proportional interest in reserves of investees accounted for by the equity method, (4) subsequent events, important economic factors, or significant uncertainties affecting particular components of the reserve quantity information, (5) whether the entity's reserves are located entirely within its home country, and (6) whether certain named governments restrict the disclosure of reserves or require that the reserve estimates include reserves other than proved.
- c. The factors considered in determining the standardized measure of discounted future net cash flows to be reported.

.05 In addition, the auditor should also—

- a. Inquire about whether the person who estimated the entity's reserve quantity information has appropriate qualifications.<sup>1</sup>
- b. Compare the entity's recent production with its reserve estimates for properties that have significant production or significant reserve quantities and inquire about disproportionate ratios.
- c. Compare the entity's reserve quantity information with the corresponding information used for depletion and amortization, and make inquiries when differences exist.
- d. Inquire about the calculation of the standardized measure of discounted future net cash flows. These inquiries might include matters such as whether—
  - i. The prices used to develop future cash inflows from estimated production of the proved reserves are based on prices received at the end of the entity's fiscal year, and whether the calculation of future cash inflows appropriately reflects the terms of sales contracts and applicable governmental laws and regulations.
  - ii. The entity's estimate of the nature and timing of future development of the proved reserves and the future rates of production are consistent with available development plans.
  - iii. The entity's estimates of future development and production costs are based on year-end

costs and assumed continuation of existing economic conditions.

- iv. Future income tax expenses have been computed using the appropriate year-end statutory tax rates, with consideration of future tax rates already legislated, after giving effect to the tax basis of the properties involved, permanent differences, and tax credits and allowances.
  - v. The future net cash flows have been appropriately discounted.
  - vi. With respect to full cost companies, the estimated future development costs are consistent with the corresponding amounts used for depletion and amortization purposes.
  - vii. With respect to the disclosure of changes in the standardized measure of discounted future net cash flows, the entity has computed and presented the sources of the changes in conformity with the requirements of FASB Statement No. 69 [AC section Oi5].
- e. Inquire about whether the methods and bases for estimating the entity's reserve information are documented and whether the information is current.

.06 If the auditor believes that the information may not be presented within the applicable guidelines, AS 2705 indicates that he ordinarily should make additional inquiries. However, because of the nature of estimates of oil and gas reserve information, the auditor may not be in a position to evaluate the responses to such additional inquiries and, thus, will need to report this limitation on the procedures prescribed by professional standards. The following is an example that illustrates reporting on oil and gas reserve information in that event.

The oil and gas reserve information is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by the Financial Accounting Standards Board. [The auditor should consider including in his report the reason(s) why he was unable to resolve his doubts. For example, the auditor may wish to state that the information was estimated by a person lacking appropriate qualifications.]

### **Footnotes (AI 19 - Required Supplementary Information: Auditing Interpretations of AS 2705):**

<sup>1</sup> For example, the Society of Petroleum Engineers has prepared "Standards Pertaining to the Estimating and Auditing of Oil and Gas Reserve Information," which indicate that a reserve estimator would normally be considered to be qualified if he or she (1) has a minimum of three years' practical experience in petroleum engineering or petroleum production geology, with at least one year of such experience being in the estimation and evaluation of reserve information; and (2) either (a) has obtained, from a college or university of recognized stature, a bachelor's or advanced degree in petroleum engineering, geology, or other discipline of engineering or physical science or (b) has

received, and is maintaining in good standing, a registered or certified professional engineer's license or a registered or certified professional geologist's license, or the equivalent thereof, from an appropriate governmental authority or professional organization.

# AI 20: Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710

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

View AS 2710, *Other Information in Documents Containing Audited Financial Statements*

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**.12 Other References by Management to Internal Control Over Financial Reporting, Including References to the Independent Auditor**

**.16 Other Information in Electronic Sites Containing Audited Financial Statements**

## [1.] Reports by Management on Internal Accounting Control

[.01-.06] [Paragraphs deleted.]

## 2. Reports by Management on Internal Control Over Financial Reporting

.07 *Question*—Communications to various parties specified in paragraph .02 of AS 2710, *Other Information in Documents Containing Audited Financial Statements*, may include a separate report by management containing an assertion about the effectiveness of the entity's internal control over financial reporting. What is the auditor's responsibility concerning such report?

.08 *Interpretation*—If the auditor has been engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting, the auditor should follow the requirement of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

.09 If the auditor has not been engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting, the auditor should follow the requirements in AS 3105.59–60.

[.10] [Paragraph deleted.]

.11 Because an auditor is required to consider internal control in an audit of the financial statements, he or she would often be familiar with matters covered in a management report on internal control over financial reporting. As a result, the auditor may become aware of information that causes him or her to believe that management's assertion on the effectiveness of internal control over financial reporting contains a material misstatement of fact as described in AS 2710.<sup>6</sup> If the auditor becomes aware of information in the report by management that conflicts with his or her knowledge or understanding of such matters, he or she should discuss the information with the client. If, after discussions with the client, the auditor concludes that a material misstatement of fact exists, the auditor should follow the guidance in AS 2710.06.

### **3. Other References by Management to Internal Control Over Financial Reporting, Including References to the Independent Auditor**

.12 *Question*—Communications to various parties specified in AS 2710.02 may include a statement by management about the entity's internal control over financial reporting. Such documents may also refer to the independent auditor in circumstances other than when the auditor has been engaged to examine and report on management's assertion about the effectiveness of internal control over financial reporting. What is the auditor's responsibility in such circumstances?

.13 *Interpretation*—The auditor should follow the guidance in AS 2710, which states that "the auditor has no obligation to perform any procedures to corroborate other information contained in [such] a document." Under AS 2710, the auditor is required to read other information in documents containing audited financial statements and consider whether it is materially inconsistent with information appearing in the financial statements and, as a result, he or she may become aware of a material misstatement of fact. If the auditor becomes aware of information in the report by management that conflicts with his or her knowledge or understanding of such matters, he or she should discuss the information with the client. If, after discussions with the client, the auditor concludes that a material misstatement of fact exists, the auditor should follow the guidance in AS 2710.06.

.14 Generally, management may discuss its responsibility for internal control over financial reporting and report on its effectiveness. In reading such information, the auditor should evaluate specific references by management that deal with the auditor's consideration of internal control in planning and performing the audit of the financial statements, particularly if such reference would lead the reader to assume the auditor had performed more work than required under PCAOB auditing standards or would lead the reader to believe that the auditor was giving assurances on internal control. The auditor should also consider whether management's comment or statement uses the auditor's name in such a way as to indicate or imply that the auditor's involvement is greater than is supported by the facts.<sup>7</sup> If management misstates the auditor's responsibility for consideration of internal control over financial reporting, the

auditor should discuss the matter with the client and consider whether any further action is needed in accordance with AS 2710.06.

.15 *AI 12, Communications About Control Deficiencies in an Audit of Financial Statements: Auditing Interpretations of AS 1305*, titled "Reporting on the Existence of Material Weaknesses" (AI 12.01-.07), permits an auditor to report to management that he or she has not become aware of any material weaknesses<sup>8</sup> during his or her audit of the financial statements, but requires such reports to be solely for the information and use of the entity's audit committee, management and others within the organization. If, however, management decides to include or refer to this communication in a general use document, the auditor should communicate to management the restrictions on use of the communication and the potential for such a statement to be misunderstood. For example, the fact that an audit has not disclosed any material weaknesses does not necessarily mean none exist since an audit of the financial statements does not constitute an examination of a management assertion about the effectiveness of internal control over financial reporting. If management refuses to make appropriate changes to the report, the auditor should advise management that he or she has not consented to the use of his or her name and should consider what other actions might be appropriate. In considering what actions, if any, may be appropriate in the circumstances, the auditor may wish to consult legal counsel.

#### 4. Other Information in Electronic Sites Containing Audited Financial Statements

.16 *Question*—An entity may make information available in public computer networks, such as the World Wide Web area of the Internet, an electronic bulletin board, the Securities and Exchange Commission's EDGAR system, or similar electronic venues (hereinafter, "electronic sites"). Information in electronic sites may include annual reports to shareholders, financial statements and other financial information, as well as press releases, product information and promotional material. When audited financial statements and the independent auditor's report thereon are included in an electronic site, what is the auditor's responsibility with respect to other information included in the electronic site?

.17 *Interpretation*—Electronic sites are a means of distributing information and are not "documents," as that term is used in AS 2710. Thus, auditors are not required by AS 2710 to read information contained in electronic sites, or to consider the consistency of other information (as that term is used in AS 2710) in electronic sites with the original documents.

.18 Auditors may be asked by their clients to render professional services with respect to information in electronic sites. Such services, which might take different forms, are not contemplated by AS 2710. Other auditing or attestation standards may apply, for example, agreed-upon procedures pursuant to AT section 201, *Agreed-Upon Procedures Engagements*, depending on the nature of the service requested.

#### Footnotes (AI 20 - Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710):

[1-4] [Footnotes deleted.]



[5] [Footnote deleted.]

6 For example, the auditor has communicated to management a material weakness in internal control over financial reporting and management states or implies there are no material weaknesses.

7 For instance, management may report that "X Company's external auditors have reviewed the company's internal control in connection with their audit of the financial statements." Because AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*, prohibits an engagement to review and report on the effectiveness of the entity's internal control over financial reporting or a written assertion thereon, a statement by management that the auditors had "reviewed" the company's internal control would be inappropriate.

8 Paragraph .08 of AS 1305, *Communications About Control Deficiencies in an Audit of Financial Statements*, prohibits a written communication that no significant deficiencies were noted during the audit. If management reports that an auditor made an oral communication that no significant deficiencies were noted during the audit, the auditor should follow the guidance in this paragraph.

# AI 21: Management Representations: Auditing Interpretations of AS 2805

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

View AS 2805, *Management Representations*

## 1. Management Representations on Violations and Possible Violations of Laws and Regulations

.01 *Question*—AS 2805, *Management Representations*, lists matters for which the auditor ordinarily obtains written representations from management. One of those matters is: Violations or possible violations of laws or regulations whose effects should be considered for disclosure in financial statements or as a basis for recording a loss contingency.

.02 Guidance on evaluating the need to disclose litigation, claims, and assessments that may result from possible violations is provided by FASB Statement No. 5, *Accounting for Contingencies* [AC section C59]. AS 2405, *Illegal Acts by Clients*, provides guidance on evaluating the materiality of illegal acts. Does the representation regarding "possible violations" include matters beyond those described in FASB Statement No. 5 [AC section C59] and AS 2405?

.03 *Interpretation*—No. AS 2805 did not change the relevant criteria for evaluating the need for disclosure of violations and possible violations of laws or regulations. In requesting the representation on possible violations, the auditor is not asking for management's speculation on all possibilities of legal challenges to its actions.

.04 The representation concerns matters that have come to management's attention and that are significant enough that they should be considered in determining whether financial statement disclosures are necessary. It recognizes that these are matters of judgment and that the need for disclosure is not always readily apparent.

## AI 22: Subsequent Discovery of Facts Existing at the Date of the Auditor's Report: Auditing Interpretations of AS 2905

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

View AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*

### 1. Auditor Association with Subsequently Discovered Information When the Auditor Has Resigned or Been Discharged

.01 *Question*—New information may come to an auditor's attention subsequent to the date of his report on audited financial statements that might affect the previously issued audit report. Is the auditor's responsibility with respect to that information different if the auditor has resigned or been discharged prior to undertaking or completing his investigation than if he were the continuing auditor?

.02 *Interpretation*—No. AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, requires the auditor to undertake to determine whether the information is reliable and whether the facts existed at the date of his report. This undertaking must be performed even when the auditor has resigned or been discharged.

# AI 23: Departures from Unqualified Opinions and Other Reporting Circumstances: Auditing Interpretations of AS 3105

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

View AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*

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**.60 Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations**

## **1. Report of an Outside Inventory-Taking Firm as an Alternative Procedure for Observing Inventories**

.01 *Question*—Paragraph .07 of AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, states that "Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors. . . ." A footnote to that paragraph states: "Circumstances such as the timing of the work may make it impossible for the auditor to accomplish these procedures. In this case, if the auditor is able to satisfy himself or herself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of the work, and the report need not include reference to the omission of the procedures or to the use of alternative procedures." Outside firms of nonaccountants

specializing in the taking of physical inventories are used at times by some companies, such as retail stores, hospitals, and automobile dealers, to count, list, price and subsequently compute the total dollar amount of inventory on hand at the date of the physical count. Would obtaining the report of an outside inventory-taking firm be an acceptable alternative procedure to the independent auditor's own observation of physical inventories?

.02 *Interpretation*—Sufficient appropriate evidential matter for inventories is discussed in paragraphs .09-.12 of AS 2510, *Auditing Inventories*. AS 2510.09 states that ". . . it is ordinarily necessary for the independent auditor to be present at the time of count and, by suitable observation, tests, and inquiries, satisfy himself respecting the effectiveness of the methods of inventory-taking and the measure of reliance which may be placed upon the client's representations about the quantities and physical condition of the inventories."

.03 AS 2510.10 and .11 discusses two variations of that procedure when the client has well-kept perpetual records that are checked periodically by comparisons with physical counts or when the client uses statistical sampling to determine inventories. In such instances, the auditor may vary the timing and extent of his observation of physical counts, but he "must be present to observe such counts as he deems necessary and must satisfy himself as to the effectiveness of the counting procedures used."

.04 AS 2510.12 deals with circumstances in which the auditor has not satisfied himself or herself as to inventories in the possession of the client through procedures described in AS 2510.09-.11. In those circumstances, the general requirement for satisfactory alternative procedures is that ". . . tests of the accounting records alone will not be sufficient for him to become satisfied as to quantities; 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."

.05 The fact that the inventory is counted by an outside inventory firm of nonaccountants is not, by itself, a satisfactory substitute for the auditor's own observation or taking of some physical counts. The auditor's concern, in this respect, is to satisfy himself as to the effectiveness of the counting procedures used. If the client engages an outside inventory firm to take the physical inventory, the auditor's primary concern would be to evaluate the effectiveness of the procedures used by the outside firm and his auditing procedures would be applied accordingly.

.06 Thus, the auditor would examine the outside firm's program, observe its procedures and controls, make or observe some physical counts of the inventory, recompute calculations of the submitted inventory on a test basis and apply appropriate tests to the intervening transactions. The independent auditor ordinarily may reduce the extent of the work on the physical count of inventory because of the work of an outside inventory firm, but any restriction on the auditor's judgment concerning the extent of his or her contact with the inventory would be a scope restriction.

## **[2.] Reporting on Comparative Financial Statements of Nonprofit Organizations**

[.07-.10] [Paragraphs deleted.]

## **[3.] Reporting on Loss Contingencies**

[.11-.14] [Paragraphs deleted.]

#### **[4.] Reports on Consolidated Financial Statements That Include Supplementary Consolidating Information**

[.15-.20] [Paragraphs deleted.]

#### **[5.] Disclosures of Subsequent Events**

[.21-.24] [Paragraphs deleted.]

#### **[6.] The Materiality of Uncertainties**

[.25-.28] [Paragraphs deleted.]

#### **[7.] Reporting on an Uncertainty**

[.29-.32] [Paragraphs deleted.]

### **8. Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting**

.33 *Question*—Footnote 6 of Statement of Position 93-3, *Rescission of Accounting Principles Board Statements*, states that an enterprise is not viewed as a going concern if liquidation appears imminent. How should the auditor report on financial statements that are prepared on a liquidation basis of accounting for an entity in liquidation or for which liquidation appears imminent?

.34 *Answer*—A liquidation basis of accounting may be considered generally accepted accounting principles for entities in liquidation or for which liquidation appears imminent. Therefore, the auditor should issue an unqualified opinion on such financial statements, provided that the liquidation basis of accounting has been properly applied, and that adequate disclosures are made in the financial statements.

.35 Typically, the financial statements of entities that adopt a liquidation basis of accounting are presented along with financial statements of a period prior to adoption of a liquidation basis that were prepared on the basis of generally accepted accounting principles for going concerns. In such circumstances, the auditor's report ordinarily should include an explanatory paragraph that states that 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 a liquidation basis.

.36 An example of the Opinion on the Financial Statements and the Basis for Opinion sections of an auditor's report on single year financial statements in the year of adoption of liquidation basis follows: <sup>1A</sup>

Opinion on the Financial Statements

We have audited the statement of net assets in liquidation of XYZ Company (the "Company") as of

December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and audited the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the net assets in liquidation of the Company as of December 31, 20X2, the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the results of its operations and its cash flows for the period from January 1, 20X2 to April 25, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described below.

As described in Note X to the financial statements, the stockholders of the Company approved a plan of liquidation on April 25, 20X2, and the Company commenced liquidation shortly thereafter. As a result, the Company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

#### Basis for Opinion

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 are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audit included performing procedures to assess the risk of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audit also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

An example of the Opinion on the Financial Statements and the Basis for Opinion sections of an auditor's report on comparative financial statements in the year of adoption of liquidation basis follows:<sup>1B</sup>

#### Opinion on the Financial Statements

We have audited the balance sheet of XYZ Company (the "Company") as of December 31, 20X1, the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and audited the statement of net assets in liquidation as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial

statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 20X1, the results of its operations and its cash flows for the year then ended and for the period from January 1, 20X2 to April 25, 20X2, its net assets in liquidation as of December 31, 20X2, and the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described below.

As described in Note X to the financial statements, the stockholders of the Company approved a plan of liquidation on April 25, 20X2, and the Company commenced liquidation shortly thereafter. As a result, the Company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

#### Basis for Opinion

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 are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risk of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

.37 The auditor may, in subsequent years, continue to include an explanatory paragraph in his report to emphasize that the financial statements are presented on a liquidation basis of accounting.

[.38] [Paragraph deleted.]

## **[9.] Quantifying Departures From Generally Accepted Accounting Principles**

[.39-.43] [Paragraphs deleted.]

## **[10.] Updated Reports Resulting From the Retroactive Suspension of Earnings Per Share and Segment Information Disclosure Requirements**

[.44-.48] [Paragraphs deleted.]



## **[11.] Restating Financial Statements Reporting on by a Predecessor Auditor**

[.49-.50] [Paragraphs deleted.]

## **12. Reference in Auditor's Unqualified Report to Management's Report**

.51 *Question*—One of the basic elements of the auditor's unqualified report is a statement that the financial statements are the responsibility of the Company's management. That statement is required in the auditor's report even when a document containing the auditor's report includes a statement by management regarding its responsibility for the presentation of the financial statements. When an annual shareholders' report (or other client-prepared document that includes audited financial statements) contains a management report that states the financial statements are the responsibility of management, is it permissible for the auditor's report to include a reference to the management report?

.52 *Interpretation*—No. The statement about management's responsibilities for the financial statements required by AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, should not be further elaborated upon in the auditor's unqualified report or referenced to management's report. Such modifications to the auditor's unqualified report may lead users to erroneously believe that the auditor is providing assurances about representations made by management about their responsibility for financial reporting, internal controls and other matters that might be discussed in the management report.

## **[13.] Reference to Country of Origin in the Auditor's Standard Report**

[.53-.55] [Paragraphs deleted.]

## **14. Reporting on Audits Conducted in Accordance with the Standards of the PCAOB and in Accordance with International Standards on Auditing**

.56 *Question*—AS 3101 requires a statement that the audit was conducted in accordance with the standards of the PCAOB. If the auditor conducts the audit in accordance with the standards of the PCAOB and in accordance with the International Standards on Auditing promulgated by the International Auditing and Assurance Standards Board of the International Federation of Accountants, may the auditor so indicate in the auditor's report?

.57 *Interpretation*—Yes. AS 3101 requires that the auditor indicate in the auditor's report that the audit was conducted in accordance with the standards of the PCAOB; however, AS 3101 does not prohibit the auditor from indicating that the audit also was conducted in accordance with another set of auditing standards. If the audit also was conducted in accordance with the International Standards on Auditing, in their entirety, the auditor may so indicate in the auditor's report. To determine whether an audit was conducted in accordance with the International Standards on Auditing, it is necessary to consider the text of the International Standards on Auditing in their entirety, including the basic principles and essential procedures together with the related guidance included in the International Standards on Auditing.

.58 When reporting on an audit performed in accordance with the standards of the PCAOB and International Standards on Auditing, the auditor should comply with reporting standards of the PCAOB.

.59 An example of reporting on an audit conducted in accordance with the standards of the PCAOB and in accordance with International Standards on Auditing follows:

#### Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB and in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audit included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audit also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

## 15. Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations<sup>2</sup>

.60 *Question*—If the prior-period financial statements audited by a predecessor auditor who has ceased operations are presented for comparative purposes with current-period audited financial statements, how is the successor auditor's report affected?

.61 *Interpretation*—If the prior-period audited financial statements are *unchanged*, pursuant to AS 3105.58 the successor auditor should indicate in the Opinion on the Financial Statements section of his or her report (a) that the financial statements of the prior period were audited by another auditor, (b) the date of the predecessor auditor's report, (c) the type of report issued by the predecessor auditor, and (d) if the report was other than an auditor's unqualified report, the substantive reasons therefor. The successor auditor ordinarily also should indicate that the other auditor has ceased operations. Footnote 18 of AS 3105 indicates that the successor auditor should not name the predecessor auditor in the report. An example of the reference that would be added to the Opinion on the Financial Statements section of the successor auditor's report is presented as follows:

The financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. Those auditors expressed an

unqualified opinion on those financial statements in their report dated March 31, 20X2.

A reference to the predecessor auditor's report should be included even if the predecessor auditor's report on the prior-period financial statements is reprinted and accompanies the successor auditor's report, because reprinting does not constitute reissuance of the predecessor auditor's report.

.62 If the prior-period financial statements *have been restated*, and the entity does not file annual financial statements with the Securities and Exchange Commission (SEC), the successor auditor should follow the guidance in paragraph .61 above, indicating that the predecessor auditor reported on such financial statements before restatement.

.63 When the prior-period financial statements have been restated, the successor auditor may be engaged either to reaudit the prior-period financial statements or to audit only the restatement adjustments. If the successor auditor is engaged to audit only the restatement adjustments and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments, the successor auditor may report on the restatement adjustments using the guidance in AS 3105.58. (The auditor also may use the guidance on alternative language contained in paragraph .71, below.) In determining the nature, timing and extent of procedures, the successor auditor should consider that a predecessor auditor who has ceased operations cannot perform the procedures to evaluate the appropriateness of the restatement adjustments as described in AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

.64 If the successor auditor neither performs a reaudit of the prior-period financial statements nor audits only the restatement adjustments, the note to the financial statements describing the restatement adjustments should be marked "Unaudited." Depending on the nature and extent of the restatement adjustments, it may be appropriate for the prior-period financial statements to be marked "Unaudited."

.65 If the entity files annual financial statements with the SEC, the SEC staff has indicated (specifically with respect to Arthur Andersen LLP) that, in annual reports (on Form 10-K and to shareholders), the predecessor auditor's latest signed and dated report on the prior-period financial statements should be reprinted with a legend indicating (a) that the report is a copy of the previously issued report and (b) that the predecessor auditor has not reissued the report.<sup>3</sup>

.66 The successor auditor should refer to the predecessor auditor's report in his or her report, as described in paragraph .61 above, and, if the prior-period financial statements *have been restated*, indicate that the predecessor auditor reported on such financial statements before restatement.

.67 SEC rules require that annual and, in some instances, other financial statements be audited. To satisfy the SEC audit requirement when the prior-period financial statements have been restated, the successor auditor may be engaged either to reaudit the prior-period financial statements or to audit only the restatement adjustments. A successor auditor who is engaged to audit only the restatement adjustments is not required to perform procedures to identify all adjustments to the financial statements that may be appropriate.<sup>4</sup>

.68 In some cases, prior-period financial statement disclosures may be revised in a manner that does

not involve restating amounts in the prior-period financial statements, but rather involves the addition of disclosures. In such cases, the successor auditor may be engaged to perform audit procedures to satisfy himself or herself as to the appropriateness of the additional disclosures. Financial statements that have been revised are considered to be restated for the purposes of this Interpretation.

.69 Some revisions may be sufficiently inconsequential such that audit procedures by the successor auditor would be unnecessary and the reference to the predecessor auditor's report on the prior-period financial statements would not indicate that the predecessor auditor reported on such financial statements before restatement. For example, inconsequential revisions might include conforming editorial modifications to footnote disclosures or reclassifications made for comparative purposes in the financial statements.<sup>5</sup>

.70 When the successor auditor is engaged to audit only the restatement adjustments, the procedures performed will vary significantly depending on the nature of adjustment. In some instances, the successor auditor may determine that conducting a reaudit of the prior-period financial statements is necessary based on the nature of the restatement adjustments. Examples of restatement adjustments whose nature indicates that a reaudit ordinarily is necessary (particularly with respect to entities that file financial statements with the SEC) include, but are not limited to:

- Corrections of an error.
- Reflection of a change in reporting entity.
- Retroactive accounting changes (*a*) with significant impact on previously reported amounts or (*b*) that affect previously reported net income or net assets.
- Reporting discontinued operations.
- Changes affecting previously reported net income or net assets.

.71 If the successor auditor is engaged to audit only the restatement adjustments and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments, the successor auditor may report on the restatement adjustments using the guidance in AS 3105.58. Alternatively, the successor auditor may wish to make it clear that he or she did not audit, review, or apply other procedures to the prior-period financial statements beyond the procedures applied to the restatement adjustments. Accordingly, he or she may include the following paragraph in his or her report:

As discussed above, the financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. As described in Note X, these financial statements have been restated [revised]. We audited the adjustments described in Note X that were applied to restate [revise] the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied. However, we were not engaged to audit, review, or apply any procedures to the 20X1 financial statements of the Company other than with respect to such adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X1 financial statements taken as a whole.

.72 If the auditor wishes to identify the procedures performed in his or her report, he or she may include in his or her report a paragraph similar to the following example:

*Restatement Adjustments for Changes in Segment Composition*

As discussed above, the financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. As described in Note X, the Company changed the composition of its reportable segments in 20X2, and the amounts in the 20X1 financial statements relating to reportable segments have been restated to conform to the 20X2 composition of reportable segments. We audited the adjustments that were applied to restate the disclosures for reportable segments reflected in the 20X1 financial statements. Our procedures included (a) agreeing the adjusted amounts of segment revenues, operating income and assets to the Company's underlying records obtained from management, and (b) testing the mathematical accuracy of the reconciliations of segment amounts to the consolidated financial statements. In our opinion, such adjustments are appropriate and have been properly applied. However, we were not engaged to audit, review, or apply any procedures to the 20X1 financial statements of the Company other than with respect to such adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X1 financial statements taken as a whole.

.73 When the revision of the prior-period financial statements is limited to expansion of footnote disclosure, the phrase "restatement adjustments" may not be applicable. In such circumstances, the auditor may include in his or her report a paragraph similar to the following example:

*Addition of FAS 142, paragraph 61, Disclosure*

As discussed above, the financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. As described in Note X, these financial statements have been revised to include the transitional disclosures required by Statement of Financial Accounting Standards (Statement) No. 142, *Goodwill and Other Intangible Assets*, which was adopted by the Company as of January 1, 20X2. Our audit procedures with respect to the disclosures in Note X with respect to 20X1 included (a) agreeing the previously reported net income to the previously issued financial statements and the adjustments to reported net income representing amortization expense (including any related tax effects) recognized in those periods related to goodwill, intangible assets that are no longer being amortized, deferred credits related to an excess over cost, equity method goodwill, and changes in amortization periods for intangible assets that will continue to be amortized as a result of initially applying Statement No. 142 (including any related tax effects) to the Company's underlying records obtained from management, and (b) testing the mathematical accuracy of the reconciliation of adjusted net income to reported net income, and the related earnings-per-share amounts. In our opinion, the disclosures for 20X1 in Note X are appropriate. However, we were not engaged to audit, review, or apply any procedures to the 20X1 financial statements of the Company other than with respect to such disclosures and, accordingly, we do not express an opinion or any other form of assurance on the 20X1 financial statements taken as a whole.

.74 *Question*—If the prior-period financial statements audited by a predecessor auditor who has ceased operations have been subsequently restated, but the successor auditor has not yet completed an audit of current-period financial statements, can the successor auditor report on the restatement adjustments pursuant to AS 3105.58?

.75 *Interpretation*—No. AS 3105.58 is only applicable when the prior-period financial statements are presented for comparative purposes with current-period audited financial statements. If the prior-period financial statements have been restated, and the successor auditor is requested to report on those financial statements without also reporting on current-period audited financial statements, the successor auditor would need to reaudit the prior-period financial statements in order to report on them.

## 16. Effect on Auditor's Report of Omission of Schedule of Investments by Investment Partnerships That Are Exempt From Securities and Exchange Commission Registration Under the Investment Company Act of 1940

[.76-.84] [Paragraphs deleted.]

### Footnotes (AI 23 - Reports on Audited Financial Statements: Auditing Interpretations of AS 3101):

[1] [Footnote deleted.]

1A The auditor's report must include the same basic elements and communication of critical audit matters as would be required in an unqualified auditor's report under AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

1B *Id.*

2 A firm is considered to have ceased operations when it no longer issues audit opinions either in its own name or in the name of a successor firm. A firm may cease operations with respect to public entities and still issue audit opinions with respect to non-public entities.

3 See Securities and Exchange Commission Release No. 33-8070, *Requirements for Arthur Andersen LLP Auditing Clients*.

4 However, a successor auditor who identifies other adjustments that may be appropriate to the prior-period financial statements, either in the course of auditing the restatement adjustments or in the audit of current-period financial statements, should consider their effect on the prior-period financial statements. See AS 2610. AS 2905 provides further guidance that may be useful to a successor auditor who either reaudits the prior-period financial statements or audits only the restatement adjustments.

5 If reclassifications result in material changes to prior-period financial statements, they should be disclosed and the successor auditor would, at a minimum, need to perform audit procedures on the related restatement adjustments.

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## AI 24: Special Reports: Auditing Interpretations of AS 3305

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

View *AS 3305, Special Reports*

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[.17-.25] [Paragraphs deleted.]

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[.32-.33] [Paragraphs deleted.]

### **[8.] Adequacy of Disclosure in Financial Statements Prepared on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles**

[.34-.39] [Paragraphs deleted.]

## **9. Auditors' Special Reports on Property and Liability Insurance Companies' Loss Reserves**

.40 *Question*—The instructions to the statutory annual statement to be filed by property and liability insurance companies with state regulatory agencies include the following:

If a company is required by its domiciliary commissioner, there is to be submitted to the commissioner as an addendum to the Annual Statement by April 1 of the subsequent year a statement of a qualified loss reserve specialist setting forth his or her opinion relating to loss and loss adjustment expense reserves.

The term "qualified loss reserve specialist" includes an independent auditor who has competency in loss reserve evaluation.

.41 If an independent auditor who has made an audit of the insurance company's financial statements in accordance with the standards of the PCAOB is engaged to express a separate opinion on the company's loss and loss adjustment expense reserves for the purpose of compliance with the above instruction, what

form of report should be used by the independent auditor?

.42 *Interpretation*—Paragraphs .11 through .18 of AS 3305, *Special Reports*, provide guidance on auditors' reports expressing an opinion on one or more specified elements, accounts, or items of a financial statement. Following are illustrations of the auditor's report expressing an opinion on a company's loss and loss adjustment expense reserves and the schedule of liabilities for losses and loss adjustment expenses that would accompany the report.<sup>5</sup>

## Illustrative report

Board of Directors

X Insurance Company

We have audited the financial statements prepared in conformity with accounting principles generally accepted in the United States of America [*or prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of .....*] of X Insurance Company as of December 31, 20X0, and have issued our report thereon dated March 1, 19X1. In the course of our audit, we have audited the estimated liabilities for unpaid losses and unpaid loss adjustment expenses of X Insurance Company as of December 31, 20X0, as set forth in the accompanying schedule including consideration of the assumptions and methods relating to the estimation of such liabilities.

In our opinion, the accompanying schedule presents fairly, in all material respects, the estimated unpaid losses and unpaid loss adjustment expenses of X Insurance Company that could be reasonably estimated at December 31, 20X0, in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ..... on a basis consistent with that of the preceding year.

This report is intended solely for the information and use of the board of directors and management of X Insurance Company and [*the state regulatory agencies to whose jurisdiction the entity is subject*] and is not intended to be and should not be used by anyone other than these specified parties.

Signature

City and State or Country

Date

## X Insurance Company

## Schedule of Liabilities for Losses

## and Loss Adjustment Expenses

**December 31, 19X0**

Liability for losses	\$xx,xxx,xxx
<hr/>	
Liability for loss adjustment expenses	x,xxx,xxx
<hr/>	
Total	\$xx,xxx,xxx
<hr/>	

**Note 1—Basis of presentation**

The above schedule has been prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ..... (Significant differences between statutory practices and generally accepted accounting principles for the calculation of the above amounts should be described but the monetary effect of any such differences need not be stated.)

Losses and loss adjustment expenses are provided for when incurred in accordance with the applicable requirements of the insurance laws [and/or regulations] of the State of ..... Such provisions include (1) individual case estimates for reported losses, (2) estimates received from other insurers with respect to reinsurance assumed, (3) estimates for unreported losses based on past experience modified for current trends, and (4) estimates of expenses for investigating and settling claims.

**Note 2—Reinsurance**

The Company reinsures certain portions of its liability insurance coverages to limit the amount of loss on individual claims and purchases catastrophe insurance to protect against aggregate single occurrence losses. Certain portions of property insurance are reinsured on a quota share basis.

The liability for losses and the liability for loss adjustment expenses were reduced by \$xxx,xxx and \$xxx,xxx, respectively, for reinsurance ceded to other companies.

Contingent liability exists with respect to reinsurance which would become an actual liability in the event the reinsuring companies, or any of them, might be unable to meet their obligations to the Company under existing reinsurance agreements.

[.43-.46] [Paragraphs deleted.]

**10.Reports on the Financial Statements Included in Internal Revenue Form 990,**

## "Return of Organizations Exempt From Income Tax"

.47 *Question*—Internal Revenue Form 990, "Return of Organizations Exempt from Income Tax," may be used as a uniform annual report by charitable organizations in some states for reporting to both state and federal governments. Many states require an auditor's opinion on whether the financial statements included in the report<sup>6</sup> are presented fairly in conformity with generally accepted accounting principles.

.48 In most states the report is used primarily to satisfy statutory requirements, but regulatory authorities make the financial statements and the accompanying auditor's report a matter of public record. In some situations, however, there may be public distribution of the report. What should be the form of the auditor's report in each of the above situations?

.49 *Interpretation*—In both situations, the auditor should first consider whether the financial statements (including appropriate notes to financial statements) are in conformity with generally accepted accounting principles. If they are, the auditor can express an unqualified opinion.

.50 If the financial statements are not in conformity with generally accepted accounting principles, the auditor should consider the distribution of the report to determine whether it is appropriate to issue a special report (as illustrated in AS 3305.08, for reporting on financial statements prepared in accordance with the requirements or financial reporting provisions of a government regulatory agency).

.51 AS 3305 permits this type of special report only if the financial statements and report are intended solely for use by those within the entity and one or more regulatory agencies to whose jurisdiction the entity is subject. However, AS 3305 makes this form of reporting appropriate, even though by law or regulation the accountant's report may be made a matter of public record.<sup>7</sup>

.52 The following example illustrates a report expressing an opinion on such special purpose financial statements:

### Report of Independent Registered Public Accounting Firm

We have audited the balance sheet (Part IV) of XYZ Charity as of December 31, 20XX, and the related statement of revenue, expenses and changes in net assets (Part I) and statement of functional expenses (Part II) for the year then ended included in the accompanying Internal Revenue Service Form 990. These financial statements are the responsibility of Charity's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As described in Note X, these financial statements were prepared in conformity with the accounting practices prescribed by the Internal Revenue Service and the Office of the State of ....., 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 fund balances of XYZ Charity as of December 31, 19XX and its revenue and expenses and changes in fund balances for the year then ended on the basis of accounting described in Note X.

Our audit was made for the purpose of forming an opinion on the above financial statements taken as a whole. The accompanying information on pages ..... to ..... is presented for purposes of additional analysis and is not a required part of the above financial statements. Such information, except for that portion marked "unaudited," on which we express no opinion, has been subjected to the auditing procedures applied in the audit of the above financial statements; and, in our opinion, the information is fairly stated in all material respects in relation to the financial statements taken as a whole.

This report is intended solely for the information and use of the board of directors and management of XYZ Charity, the Internal Revenue Service, and the Office of the State of ..... and is not intended to be and should not be used by anyone other than these specified parties.

*[Signature]*

*[City and State or Country]*

*[Date]*

.53 If there is public distribution<sup>9</sup> of the report, because the law requires it or otherwise (copies of Form 990 are distributed to contributors or others without receiving a specific request for such distribution) and the financial statements included in it are not in conformity with generally accepted accounting principles, a special report (as illustrated in AS 3305.08) is not appropriate. In such cases, the auditor should express a qualified or adverse opinion and disclose the effects on the financial statements of the departures from generally accepted accounting principles if the effects are reasonably determinable. If the effects are not reasonably determinable, the report should so state.

[.54] [Paragraph deleted.]

## **11. Reporting on Current-Value Financial Statements That Supplement Historical-Cost Financial Statements in Presentations of Real Estate Entities**

.55 *Question*—A real estate entity presents current-value financial statements<sup>10</sup> to supplement historical-cost financial statements. May an auditor accept an engagement to report on current-value financial statements that supplement historical-cost financial statements, and if so, how should the auditor report?

.56 *Interpretation*—An auditor may accept an engagement to report on current-value financial

statements that supplement historical-cost financial statements of a real estate entity only if the auditor believes the following two conditions exist—

- the measurement and disclosure criteria used to prepare the current-value financial statements are reasonable, and
- competent persons using the measurement and disclosure criteria would ordinarily obtain materially similar measurements or disclosures.

.57 If these conditions are satisfied, an auditor may report on such current-value financial statements in a manner similar to that discussed in AS 3305.29. However, because the current-value financial statements only supplement the historical-cost financial statements and are not presented as a stand-alone presentation, it is not necessary to restrict the use of the auditor's report on the presentation as required by that paragraph.

.58 The following is an example of a report an auditor might issue when reporting on current-value financial statements that supplement historical-cost financial statements of a real estate entity:

Report of Independent Registered Public Accounting Firm

We have audited the accompanying historical-cost balance sheets of X Company as of December 31, 20X3 and 20X2, and the related historical-cost statements of income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 20X3. We also have audited the supplemental current-value balance sheets of X Company as of December 31, 20X3 and 20X2, and the related supplemental current-value statements of income and shareholders' equity for each of the three years in the period ended December 31, 20X3. 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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the historical-cost financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X3, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 1, the supplemental current-value financial statements have been prepared by management to present relevant financial information that is not provided by the historical-cost financial statements and are not intended to be a presentation in conformity with generally

accepted accounting principles. In addition, the supplemental current-value financial statements do not purport to present the net realizable, liquidation, or market value of the Company as a whole. Furthermore, amounts ultimately realized by the Company from the disposal of properties may vary significantly from the current values presented.

In our opinion, the supplemental current-value financial statements referred to above present fairly, in all material respects, the information set forth in them on the basis of accounting described in Note 1.

[Signature]

[City and State or Country]

[Date]

.59 The auditor should also consider the adequacy of disclosures relating to the current value financial statements. Such disclosures should describe the accounting policies applied and such matters as the basis of presentation, nature of the reporting entity's properties, status of construction-in-process, valuation bases used for each classification of assets and liabilities, and sources of valuation. These matters should be disclosed in the notes in a sufficiently clear and comprehensive manner that enables a knowledgeable reader to understand the current-value financial statements.

## **12.Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis**

.60 *Question*—Insurance enterprises issue financial statements prepared in accordance with accounting practices prescribed or permitted by insurance regulators (a "statutory basis") in addition to, or instead of, financial statements prepared in accordance with generally accepted accounting principles (GAAP). Effective January 1, 2001, most states are expected to adopt a comprehensively updated *Accounting Practices and Procedures Manual*, as revised by the National Association of Insurance Commissioners' (NAIC's) Codification project. The updated *Accounting Practices and Procedures Manual*, along with any subsequent revisions, is referred to as the revised Manual. The revised Manual contains extensive disclosure requirements. As a result, after a state adopts the revised Manual, its statutory basis of accounting will include informative disclosures appropriate for that basis of accounting. The NAIC Annual Statement Instructions prescribe the financial statements to be included in the annual audited financial report. Some states may not adopt the revised Manual or may adopt it with significant departures. How should auditors evaluate whether informative disclosures in financial statements prepared on a statutory basis are appropriate?<sup>11</sup>

.61 *Interpretation*—Financial statements prepared on a statutory basis are financial statements prepared on a comprehensive basis of accounting other than GAAP according to AS 3305.04. AS 3305.09 states that "When reporting on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used. The auditor should apply essentially the same criteria to financial statements

prepared on an other comprehensive basis of accounting as those applied 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 paragraph .04 of AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles."*

.62 AS 3305.02 states that the standards of the PCAOB apply when an auditor conducts an audit of and reports on financial statements prepared on an other comprehensive basis of accounting. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

.63 *Question*—What types of items or matters should auditors consider in evaluating whether informative disclosures are reasonably adequate?

.64 *Interpretation*—AS 3305.09 and .10 indicates that financial statements prepared on a comprehensive basis of accounting other than GAAP should include all informative disclosures that are appropriate for the basis of accounting used. That includes a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from GAAP. AS 3305.10 also states that when "the financial statements [prepared on an other comprehensive basis of accounting] contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate."

[.65-.66] [Paragraphs deleted.]

.67 *Question*—How does the auditor evaluate whether "similar informative disclosures" are appropriate for—

- a. Items and transactions that are accounted for essentially the same or in a similar manner under a statutory basis as under GAAP?
- b. Items and transactions that are accounted for differently under a statutory basis than under GAAP?
- c. Items and transactions that are accounted for differently under requirements of the state of domicile than under the revised Manual?

.68 *Interpretation*—Disclosures in statutory basis financial statements for items and transactions that are accounted for essentially the same or in a similar manner under the statutory basis as under GAAP should be the same as, or similar to, the disclosures required by GAAP unless the revised Manual specifically states the NAIC Codification rejected the GAAP disclosures. Disclosures should also include those required by the revised Manual.

[.69] [Paragraph deleted.]

.70 Disclosures in statutory basis financial statements for items or transactions that are accounted for differently under the statutory basis than under GAAP, but in accordance with the revised Manual, should



be the disclosures required by the revised Manual.

.71 If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised Manual for that item or transaction, but it is in accordance with GAAP or superseded GAAP, the disclosures in statutory basis financial statements for that item or transaction should be the applicable GAAP disclosures for the GAAP or superseded GAAP. If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised Manual, GAAP or superseded GAAP, sufficient relevant disclosures should be made.

[.72-.76] [Paragraphs deleted.]

.77 When evaluating the adequacy of disclosures, the auditor should also consider disclosures related to matters that are not specifically identified on the face of the financial statements, such as (a) related party transactions, (b) restrictions on assets and owners' equity, (c) subsequent events, and (d) uncertainties. Other matters should be disclosed if such disclosures are necessary to keep the financial statements from being misleading.

[.78-.79] [Paragraphs deleted.]

.80 *Question*—There may also be instances in which state requirements have not been revised to reflect a new GAAP disclosure requirement. What are the disclosure requirements in those situations?

.81 *Interpretation*—Until state requirements are determined, the statutory basis financial statements should include disclosures required by new GAAP requirements that are relevant and significant to the statutory basis of accounting, pending acceptance or rejection for inclusion in the revised Manual.

### **13. Reporting on a Special-Purpose Financial Statement That Results in an Incomplete Presentation but Is Otherwise in Conformity With Generally Accepted Accounting Principles**

.82 *Question*—An auditor may be requested to report on a special-purpose financial statement that results in an incomplete presentation but otherwise is in conformity with generally accepted accounting principles. For example, an entity wishing to sell a division or product line may prepare an offering memorandum that includes a special-purpose financial statement that presents certain assets and liabilities, revenues and expenses relating to the division or product line being sold. AS 3305.22 states that the auditor may report on a special-purpose financial statement prepared to comply with a contractual agreement. Does an offering memorandum (not including a filing with a regulatory agency) constitute a contractual agreement for purposes of issuing an auditor's report under this section?

.83 *Interpretation*—No. An offering memorandum generally is a document providing information as the basis for negotiating an offer to sell certain assets or businesses or to raise funds. Normally, parties to an agreement or other specified parties for whom the special-purpose financial presentation is intended have not been identified. Accordingly, the auditor should follow the reporting guidance in AS 3105.18–.27 and .40–.43.

.84 *Question*—Does an agreement between a client and one or more third parties other than the

auditor to prepare financial statements using a special-purpose presentation constitute a contractual agreement for purposes of issuing an auditor's report under this section?

.85 *Interpretation*—Yes. In such cases, the auditor should follow the guidance in AS 3305.22-.26, and use of the auditor's report should be restricted to those within the entity, to the parties to the contract or agreement or to those with whom the entity is negotiating directly.

.86 If there is no such agreement, the auditor should follow the guidance in AS 3105.18-.27 and .40-.43.

[.87-.89] [Paragraphs deleted.]

## **14. Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting**

.90 *Question*—AS 3305.10, requires that financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles (GAAP) include a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from GAAP. It also states that when such financial statements contain items that are the same as, or similar to, those in statements prepared in conformity with GAAP, "similar informative disclosures are appropriate." To illustrate how to apply that statement, AS 3305.10 says that the disclosures for depreciation, long-term debt, and owners' equity should be "comparable to" those in financial statements prepared in conformity with GAAP. That paragraph then states that the auditor "should also consider" the need for disclosure of matters that are not specifically identified on the face of the statements, such as (a) related party transactions, (b) restrictions on assets and owners' equity, (c) subsequent events, and (d) uncertainties. How should the guidance in AS 3305.10 be applied in evaluating the adequacy of disclosure in financial statements prepared on the cash, modified cash, or income tax basis of accounting?

.91 *Interpretation*—The discussion of the basis of presentation may be brief; for example: "The accompanying financial statements present financial results on the accrual basis of accounting used for federal income tax reporting." Only the primary differences from GAAP need to be described. To illustrate, assume that several items are accounted for differently than they would be under GAAP, but that only the differences in depreciation calculations are significant. In that situation, a brief description of the depreciation differences is all that would be necessary, and the remaining differences need not be described. Quantifying differences is not required.

.92 If cash, modified cash, or income tax basis financial statements contain elements, accounts, or items for which GAAP would require disclosure, the statements should either provide the relevant disclosure that would be required for those items in a GAAP presentation or provide information that communicates the substance of that disclosure. That may result in substituting qualitative information for some of the quantitative information required for GAAP presentations. For example, disclosing the repayment terms of significant long-term borrowings may sufficiently communicate information about future principal reduction without providing the summary of principal reduction during each of the next five years that would be required for a GAAP presentation. Similarly, disclosing estimated percentages of revenues, rather than amounts that GAAP presentations would require, may sufficiently convey the

significance of sales or leasing to related parties. GAAP disclosure requirements that are not relevant to the measurement of the element, account, or item need not be considered. To illustrate:

- a. The fair value information that FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* [AC section I80], would require disclosing for debt and equity securities reported in GAAP presentations would not be relevant when the basis of presentation does not adjust the cost of such securities to their fair value.
- b. The information based on actuarial calculations that FASB Statement No. 87, *Employers' Accounting for Pensions* [AC section P16], would require disclosing for contributions to defined benefit plans reported in GAAP presentations would not be relevant in income tax or cash basis financial statements.

.93 If GAAP sets forth requirements that apply to the presentation of financial statements, then cash, modified cash, and income tax basis statements should either comply with those requirements or provide information that communicates the substance of those requirements. The substance of GAAP presentation requirements may be communicated using qualitative information and without modifying the financial statement format. For example:

- a. Information about the effects of accounting changes, discontinued operations, and extraordinary items could be disclosed in a note to the financial statements without following the GAAP presentation requirements in the statement of results of operations, using those terms, or disclosing net-of-tax effects.
- b. Instead of showing expenses by their functional classifications, the income tax basis statement of activities of a trade organization could present expenses according to their natural classifications, and a note to the statement could use estimated percentages to communicate information about expenses incurred by the major program and supporting services. A voluntary health and welfare organization could take such an approach instead of presenting the matrix of natural and functional expense classifications that would be required for a GAAP presentation, or, if information has been gathered for the Form 990 matrix required for such organizations, it could be presented either in the form of a separate statement or in a note to the financial statements.
- c. Instead of showing the amounts of, and changes in, the unrestricted and temporarily and permanently restricted classes of net assets, which would be required for a GAAP presentation, the income tax basis statement of financial position of a voluntary health and welfare organization could report total net assets or fund balances, the related statement of activities could report changes in those totals, and a note to the financial statements could provide information, using estimated or actual amounts or percentages, about the restrictions on those amounts and on any deferred restricted amounts, describe the major restrictions, and provide information about significant changes in restricted amounts.

.94 Presentations using the cash basis of accounting, the modified cash basis, or the cash basis used for income tax reporting often include a presentation consisting entirely or mainly of cash receipts and disbursements. Such presentations need not conform with the requirements for a statement of cash flows

that would be included in a GAAP presentation. While a statement of cash flows is not required in presentations using the cash, modified cash, or income tax basis of accounting, if a presentation of cash receipts and disbursements is presented in a format similar to a statement of cash flows or if the entity chooses to present such a statement, for example in a presentation on the accrual basis of accounting used for federal income tax reporting, the statement should either conform to the requirements for a GAAP presentation or communicate their substance. As an example, the statement of cash flows might disclose noncash acquisitions through captions on its face.

.95 If GAAP would require disclosure of other matters, the auditor should consider the need for that same disclosure or disclosure that communicates the substance of those requirements. Some examples are contingent liabilities, going concern considerations, and significant risks and uncertainties. However, the disclosures need not include information that is not relevant to the basis of accounting. To illustrate, the general information about the use of estimates that is required to be disclosed in GAAP presentations by Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, would not be relevant in a presentation that has no estimates, such as one based on cash receipts and disbursements.

### Footnotes (AI 24 - Special Reports: Auditing Interpretations of AS 3305):

[1-4] [Footnote deleted.]

<sup>5</sup> If a significant period of time has elapsed between the date of the report on the financial statements and the date he is reporting on the loss and loss adjustment expense reserves, the auditor may wish to include the following paragraph after the opinion paragraph: Because we have not audited any financial statements of X Insurance Company as of any date or for any period subsequent to December 31, 20X0, we have no knowledge of the effects, if any, on the liability for unpaid losses and unpaid loss adjustment expenses of events that may have occurred subsequent to the date of our audit.

<sup>6</sup> As used in this interpretation, the report refers to a Form 990 report by a charitable organization in a filing with a government agency.

<sup>7</sup> *Public record*, for purposes of auditors' reports in states with filing requirements for exempt organizations, includes circumstances in which specific requests must be made by the public to obtain access to or copies of the report, notwithstanding the fact that some states may advertise or require the exempt organization to advertise the availability of Form 990. In contrast, *public distribution*, for purposes of auditors' reports in state filings on various Forms 990 dealing with exempt organizations, includes circumstances in which the regulatory agency or the exempt organization, either because of regulatory requirements or voluntarily, distributes copies of Form 990 to contributors or others without receiving a specific request for such distribution.

[8] [Footnote deleted.]

<sup>9</sup> Auditors should consider whether there is a public distribution requirement by reference to the relevant state law. However, at this time (April 1982), most state laws do not contain a public distribution requirement and a special report is ordinarily appropriate. For example, the laws of New York, New Jersey and Connecticut do not presently require public distribution as defined by this interpretation.

10 Generally accepted accounting principles require the use of current-value accounting for financial statements of certain types of entities (for example, investment companies, employee benefit plans, personal financial statements, and mutual and common trust funds). This interpretation does not apply to reports on current-value financial statements of such entities. The auditor engaged to report on current-value financial statements of such entities should follow the guidance in AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*.

11 It is possible for one of three different situations to occur: The state adopted the revised Manual without significant departures, adopted the revised Manual with significant departures, or has not yet adopted the revised Manual.

## AI 25: Association with Financial Statements: Auditing Interpretations of AS 3320

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

View [AS 3320](#), *Association with Financial Statements*

### Summary Table of Contents

**.01 Annual Report Disclosure of Unaudited Fourth Quarter Interim Data**

**.15 Auditor's Identification With Condensed Financial Data**

**.19 Applicability of Guidance on Reporting When Not Independent**

### 1. Annual Report Disclosure of Unaudited Fourth Quarter Interim Data

.01 *Question*—APB Opinion No. 28, paragraph 31 [AC section 173.147], which applies to publicly traded companies, states: "If interim financial data and disclosures are not separately reported for the fourth quarter, security holders often make inferences about that quarter by subtracting data based on the third quarter interim report from the annual results. In the absence of a separate fourth quarter report or disclosure of the results . . . for that quarter in the annual report, disposals of segments of a business and extraordinary, unusual, or infrequently occurring items recognized in the fourth quarter, as well as the aggregate effect of year-end adjustments which are material to the results of that quarter . . . shall be disclosed in the annual report in a note to the annual financial statements." Does the auditor have an obligation, arising from the disclosure requirements of paragraph 31 of Opinion No. 28 [AC section 173.147], to audit interim data?

.02 *Interpretation*—No. If the auditor has not been specifically engaged to audit interim information, he does not have an obligation to audit interim data as a result of his audit of the annual financial statements.

.03 Disclosure of fourth quarter adjustments and other disclosures required by paragraph 31 [AC

section 173.147] would appear in a note to the annual financial statements of a publicly traded company only if fourth quarter data were not separately distributed or did not appear elsewhere in the annual report. Consequently, such disclosures are not essential for a fair presentation of the annual financial statements in conformity with generally accepted accounting principles.

.04 If interim financial data and disclosures are not separately reported (as outlined in paragraph 30 of Opinion No. 28 [AC section 173.146]) for the fourth quarter, the independent auditor, during his audit of the annual financial statements, should inquire as to whether there are fourth quarter items that need to be disclosed in a note to the annual financial statements.

.05 Information on fourth quarter adjustments and similar items that appear in notes to the annual financial statements to comply with paragraph 31 of Opinion No. 28 [AC section 173.147] would ordinarily not be audited separately and, therefore, the information would be labeled "unaudited" or "not covered by auditor's report."

.06 If a publicly traded company fails to comply with the provisions of paragraph 31 of Opinion No. 28 [AC section 173.147], the auditor should suggest appropriate revision; failing that, he should call attention in his report to the omission of the information. The auditor need not qualify his opinion on the annual financial statements since the disclosure is not essential for a fair presentation of those statements in conformity with generally accepted accounting principles.

.07 Reference should be made to AS 4105, *Reviews of Interim Financial Information*, for guidance with respect to reviews of interim financial information of SEC registrants or non-SEC registrants that make a filing with a regulatory agency in preparation for a public offering or listing.

## **[2.] Association of the Auditor of an Acquired Company With Unaudited Statements in a Listing Application**

[.08-.12] [Paragraphs deleted.]

## **[3.] Association of the Auditor of the Acquiring Company with Unaudited Statements in a Listing Application**

[.13-.14] [Paragraphs deleted.]

## **4. Auditor's Identification With Condensed Financial Data**

.15 *Question*—Paragraph .01 of AS 3320, *Association with Financial Statements*, states in part: "In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking." AS 3320.03 states that "An accountant is associated with financial statements when he has consented to the use of his name in a report, document, or written communication containing the statements." Is the auditor "associated" with condensed financial data when he is identified by a financial reporting service as being a company's independent auditor or when his report is reproduced and presented with such data?

.16 *Interpretation*—No. The accountant has not consented to the use of his name when it is published by a financial reporting service. Financial data released to the public by a company and the name of its auditor are public information. Accordingly, neither the auditor nor his client has the ability to require a financial reporting service to withhold publishing such information.

.17 Financial reporting services, such as Dun & Bradstreet and Moody's Investors Service, furnish to subscribers information and ratings concerning commercial enterprises as a basis for credit, insurance, marketing and other business purposes. Those reports frequently include condensed financial data and other data such as payments to trade creditors, loan experience with banks, a brief history of the entity and a description of its operations. Also, as part of its report, the financial service often discloses the names of the officers and directors or principals or owners of the company and the name of the company's auditor.

.18 In the context in which the auditor's name appears, it is doubtful that readers will assume that he has audited the information presented. However, the AICPA has suggested to certain financial reporting services that they identify data as "unaudited" if the data has been extracted from unaudited financial statements. Also, the AICPA has suggested that when summarized financial data is presented together with an auditor's report on complete financial statements (including notes), the financial reporting services state that the auditor's report applies to the complete financial statements which are not presented.

## 5. Applicability of Guidance on Reporting When Not Independent

.19 *Question*—AS 3320 describes the reporting responsibilities of the certified public accountant who has determined that he is not independent with respect to financial statements with which he is associated. That section, however, does not indicate how he should determine whether he is independent. What should the certified public accountant consider in determining whether he is independent? Also, should his consideration be any different for an engagement to prepare unaudited financial statements?

.20 *Interpretation*—AS 3320 explains the certified public accountant's reporting responsibilities when he is not independent. However, it does not attempt to explain how the certified public accountant determines whether he is independent because that is a question of professional ethics.

.21 PCAOB Rules establish requirements regarding auditor independence.

.22 AS 3320.10 states that the reporting guidance applies, *regardless of the extent of procedures applied*, (emphasis added) in all circumstances other than when the financial statements are those of a non-public entity.<sup>1</sup> Thus, the accountant's consideration of whether he is independent should be the same whether the financial statements are audited or unaudited.

## [6.] Reporting on Solvency

[.23-.35] [Paragraphs deleted.]



**Footnotes (AI 25 - Association with Financial Statements: Auditing Interpretations of AS 3320):**

<sup>1</sup> If the financial statements are those of a non-public entity, the accountant should look to the guidance in Statements on Standards for Accounting and Review Services.

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# AI 26: Responsibilities Regarding Filings Under Federal Securities Statutes: Auditing Interpretations of AS 4101

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

View AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*

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**.01 Subsequent Events Procedures for Shelf Registration Statements Updated after the Original Effective Date**

**.12 Consenting to be Named as an Expert in an Offering Document in Connection With Securities Offerings Other Than Those Registered Under the Securities Act of 1933**

**.16 Consenting to the Use of an Audit Report in an Offering Document in Securities Offerings Other Than One Registered Under the Securities Act of 1933**

## 1. Subsequent Events Procedures for Shelf Registration Statements Updated After the Original Effective Date

.01 *Question*—Rule 415 of Regulation C under the Securities Act of 1933 (1933 Act) permits companies to register a designated amount of securities for continuous or delayed offerings by filing one "shelf" registration statement with the SEC. Under this rule, a registrant can register an amount of securities it reasonably expects to offer and sell within the next two years, generally without the later need to prepare and file a new prospectus and registration statement for each sale.

.02 A Rule 415 shelf registration statement can be updated after its original effective date by—

- a. The filing of a post-effective amendment,
- b. The incorporation by reference of subsequently filed material, or

- c. The addition of a supplemental prospectus (sometimes referred to as a "sticker").

.03 Paragraph .05 of AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*, states, "Because a registration statement under the Securities Act of 1933 speaks as of its effective date, the independent accountant whose report is included in such a registration statement has a statutory responsibility that is determined in the light of the circumstances on that date." The independent accountant's statutory responsibility regarding information covered by his report and included in a registration statement is specified in Section 11 of the 1933 Act. Section 11(b)(3)(B) states that the accountant will not be held liable if he can sustain a burden of proof that "he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." To sustain the burden of proof that he has made a "reasonable investigation" as of the effective date, the accountant performs subsequent events procedures (as described in AS 4101.10 and .11) to a date as close to the effective date of the registration statement as is reasonable and practicable in the circumstances.

.04 In connection with Rule 415 shelf registrations, under what circumstances does the independent accountant have a responsibility to perform subsequent events procedures after the original effective date of the registration statement?

.05 *Interpretation*—As discussed in more detail below, in general, the accountant should perform the subsequent events procedures described in AS 4101.10 and .11, when either:

- a. A post-effective amendment to the shelf registration statement, as defined by SEC rules, is filed pursuant to Item 512(a) of Regulation S-K,<sup>1</sup> or
- b. A 1934 Act filing that includes or amends audited financial statements is incorporated by reference into the shelf registration statement.

.06 When a post-effective amendment is filed pursuant to the registrant's undertaking required by Item 512 of Regulation S-K, a shelf registration statement is considered to have a new effective date because Item 512(a)(2) of Regulation S-K states, ". . . for the purpose of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement. . . ." Accordingly, in such cases, the accountant should perform subsequent events procedures to a date as close to the new effective date of the registration statement as is reasonable and practicable in the circumstances.

.07 Item 512(b) of Regulation S-K states that for purposes of determining any liability under the Securities Act of 1933 each filing of a registrant's annual report (Form 10-K) and each filing of an employee benefit plan annual report (Form 11-K) that is incorporated by reference into a shelf registration statement is deemed to be a new registration statement relating to the securities offering. Accordingly, when a Form 10-K or Form 11-K is incorporated by reference into a shelf registration statement, the accountant should perform subsequent events procedures to a date as close to the date of the filing of the Form 10-K or Form 11-K as is reasonable and practicable in the circumstances and date his consent as of

that date.

.08 In many circumstances, a Form 10-Q, Form 8-K, or other 1934 Act filing can be incorporated by reference into a shelf registration statement (sometimes this occurs automatically—for example, in a Form S-3 or Form S-8) without the need for a post-effective amendment. In those circumstances, the accountant has no responsibility to perform subsequent events procedures unless the filing includes or amends audited financial statements—for example, a Form 8-K that includes audited financial statements of an acquired company. In these latter circumstances, when the filing is incorporated into a registration statement, SEC rules require a currently dated consent of the accountant who audited those statements, and that accountant should perform subsequent events procedures to a date as close to the date of the incorporation by reference of the related material as is reasonable and practicable in the circumstances.<sup>2</sup>

.09 In addition, an accountant's report on a review of interim financial information contained in a Form 10-Q may also include his report on the information presented in the condensed year-end balance sheet that has also been included in the form and has been derived from the latest audited annual balance sheet. (See paragraph .08 of AS 3315, *Reporting on Condensed Financial Statements and Selected Financial Data*.) When the Form 10-Q is incorporated by reference into the shelf registration (which may occur automatically), the report on the year-end condensed balance sheet may be considered a report of an "expert." Because it is not clear what the accountant's responsibility is in those circumstances, the accountant should perform subsequent events procedures (as described in AS 4101.10 and .11) to a date as close to the date of the incorporation by reference of the Form 10-Q as is reasonable and practicable in the circumstances.

.10 One of the subsequent events procedures described in AS 4101 is to "read the entire prospectus and other pertinent portions of the registration statement." The reading of the entire prospectus (including any supplemental prospectuses and documents incorporated by reference—such as Form 10-Ks, 10-Qs, and 8-Ks) and the other procedures described in AS 4101.10 and .11, help assure that the accountant has fulfilled his statutory responsibilities under the 1933 Act to perform a "reasonable investigation."

.11 When a shelf registration statement is updated by a supplemental prospectus (or "sticker"), the effective date of the registration statement is considered to be unchanged since the supplemental prospectus does not constitute an amendment to the registration statement, and, consequently, no posteffective amendment has been filed. Accordingly, an accountant has no responsibility to update his performance of subsequent events procedures through the date of the supplemental prospectus or sticker. The accountant, however, may nevertheless become aware that facts may have existed at the date of his report that might have affected his report had he then been aware of those facts. AS 4101.12 and .13, provide guidance on the accountant's response to subsequent events and subsequently discovered facts.

## **2. Consenting to Be Named as an Expert in an Offering Document in Connection with Securities Offerings Other Than Those Registered Under the Securities Act of 1933**

.12 *Question*—Should the auditor consent to be named, or referred to, as an expert in an offering document in connection with securities offerings other than those registered under the Securities Act of 1933 (the Act)?

.13 *Interpretation*—No. The term "expert" has a specific statutory meaning under the Act.<sup>3</sup> The act states that anyone who purchases a security registered under the Act may sue specified persons if the registration statement contains an untrue statement or omits to state a material fact. Those persons who may be sued include "every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement." These persons are typically referred to as "experts." Auditors sign a statement, known as a consent, in which they agree to be identified as experts in a section of the registration statement.

.14 Outside the 1933 Act arena, however, the term "expert" is typically undefined and the auditor's responsibility, as a result of the use of that term, is also undefined.

.15 When a client wishes to make reference to the auditor's role in an offering document in connection with a securities offering that is not registered under the Act, the caption "Independent Auditors" should be used to title that section of the document; the caption "Experts" should not be used, nor should the auditors be referred to as experts anywhere in the document. The following paragraph should be used to describe the auditors role.

#### Independent Auditors

The financial statements as of December 31, 19XX and for the year then ended, included in this offering circular, have been audited by ABC, independent auditors, as stated in their report(s) appearing herein.

If the client refuses to delete from the offering document the reference to the auditors as experts, the auditor should not permit inclusion of the auditor's report in the offering document.

### **3. Consenting to the Use of an Audit Report in an Offering Document in Securities Offerings Other Than One Registered Under the Securities Act of 1933**

.16 *Question*—May the auditor consent to the use of his or her audit report in an offering document other than one registered under the Securities Act of 1933?

.17 *Interpretation*—When an auditor's report is included in an offering document other than one registered under the Securities Act of 1933, it is not usually necessary for the accountant to provide a consent. If the accountant is requested to provide a consent, he or she may do so. The following is example language the accountant might use:

We agree to the inclusion in this offering circular of our report, dated February 5, 19XX, on our audit of the financial statements of [name of entity].

## Footnotes (AI 26 - Responsibilities Regarding Filings Under Federal Securities Statutes: Auditing Interpretations of AS 4101):

- <sup>1</sup> Item 512(a) of Regulation S-K provides that the registrant is required to undertake to file a post-effective amendment to a shelf registration statement to (a) file updated financial statements pursuant to section 10(a)(3) of the Securities Act of 1933, (b) reflect a "fundamental change" in the information in the registration statement arising from facts or events occurring after the effective date of the registration statement or previous post-effective amendments, or (c) include new material information regarding the plan of distribution.
- <sup>2</sup> Typically in such cases, the affected audited financial statements are not those of the registrant, and accordingly, there would be no requirement for the registrant's auditor to update his subsequent events procedures with respect to the registrant's financial statements.
- <sup>3</sup> If the term "expert" is defined under applicable state law, for instance, the accountant may agree to be named as an expert in an offering document in an intra-state securities offering. The accountant may also agree to be named as an expert, as that term is used by the Office of Thrift Supervision (OTS), in securities offering documents which are subject to the jurisdiction of the OTS.

# AI 27: Letters for Underwriters and Certain Other Requesting Parties: Auditing Interpretations of AS 6101

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

View AS 6101, *Letters for Underwriters and Certain Other Requesting Parties*

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### **.01 Letters to Directors Relating to Annual Reports on Form 10-K**

### **.13 Commenting in a Comfort Letter on Quantitative Disclosures About Market Risk Made in Accordance With Item 305 of Regulation S-K**

## **1. Letters to Directors Relating to Annual Reports on Form 10-K**

.01 *Question*—Annual reports to the Securities and Exchange Commission (SEC) on Form 10-K must be signed by at least a majority of the registrant's board of directors. In reviewing the Form 10-K, directors may seek the involvement of the registrant's independent auditors and other professionals.

.02 What types of services could the auditor perform at the request of the board of directors in connection with the Form 10-K? For example, is it permissible for the auditor to comment on compliance of the registrant's Form 10-K with the requirements of the various SEC rules and regulations?

.03 *Interpretation*—The auditor can express an opinion to the board of directors on whether the financial statements and financial statement schedules audited comply as to form with the applicable accounting requirements of the Securities Exchange Act of 1934 and the related rules and regulations thereunder adopted by the SEC (see paragraph .33 of AS 6101, *Letters for Underwriters and Certain Other Requesting Parties*).<sup>2</sup>

.04 The auditor may affirm to the board of directors that under the standards of the PCAOB the auditor is required to read the information in addition to audited financial statements contained in the

Form 10-K, for the purpose of considering whether such information may be materially inconsistent with information appearing in the financial statements (*see AS 2710, Other Information in Documents Containing Audited Financial Statements*). However, the report to the board of directors should state that the auditor has no obligation to perform any procedures to corroborate such information.

.05 In addition, the auditor could perform, at the request of the board of directors, specified procedures and report the results of those procedures concerning various information contained in the Form 10-K such as tables, statistics and other financial information. There should be a clear understanding with the board as to the nature, extent and limitations of the procedures to be performed and as to the kind of report to be issued. Although the guidance provided in AS 6101 is intended primarily for auditors issuing a letter to underwriters and certain other requesting parties in connection with an offering of securities, the guidance in AS 6101.54-.60 would also be applicable when the auditor is asked to furnish a letter to the board of directors in connection with the filing of Form 10-K under the Securities Exchange Act of 1934.<sup>3</sup> The types of information on which auditors may comment are described in AS 6101.55. The auditor should comment only on that information if the criteria in AS 6101.55 and .57 have been met. The comments should be made in the form of description of procedures performed and findings obtained, ordinarily expressed in terms of agreement between items compared.

.06 Certain financial information in Form 10-K is included because of specific requirements of Regulation S-K. The auditor may comment as to whether this information is in conformity with the disclosure requirements of Regulation S-K if the conditions in AS 6101.57 are met. AS 6101.57 identifies the disclosure requirements of Regulation S-K that generally meet those conditions. The auditor is limited to giving negative assurance, since this information is not given in the form of financial statements and generally has not been audited by the accountants. (*See AS 6101.57.*)

.07 The auditor should not comment on matters that are primarily subjective or judgmental in nature such as those included in Item 7 of Form 10-K, "Management's Discussion and Analysis of Financial Condition and Results of Operations." For example, changes between periods in gross profit ratios may be caused by factors that are not necessarily within the expertise of auditors. However, the auditor can comment on specific changes in comparative amounts that are included in management's discussion if the amounts used to compute such changes are obtained from the financial statements or accounting records as discussed in AS 6101.55, but cannot comment with respect to the appropriateness of the explanations.

.08 There are no criteria by which to measure the sufficiency of the procedures performed by the accountants for the directors' purposes. Ordinarily the auditor should discuss with the directors or the audit committee the procedures to be performed and may suggest procedures that might be meaningful in the circumstances. However, the auditor should clearly indicate to the board of directors that the auditor cannot make any representations as to whether the agreed-upon procedures are sufficient for the directors' purposes.

.09 It should not ordinarily be necessary for the auditor to reaffirm the auditor's independence to the board of directors. If such a representation is requested, however, the auditor may include in the letter a statement similar to that described in AS 6101.31.

## **[2.] Negative Assurance on Unaudited Condensed Interim Financial Statements**



## Attached to Comfort Letters

[.10-.12] [Paragraphs deleted.]

### 3. Commenting in a Comfort Letter on Quantitative Disclosures About Market Risk Made in Accordance With Item 305 of Regulation S-K

.13 *Introduction*—Regulation S-K, Item 305, *Quantitative and Qualitative Disclosures About Market Risk*, requires certain quantitative and qualitative disclosures with respect to—

- a. Derivative financial instruments, generally as defined in Financial Accounting Standards Board (FASB) Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* [AC section F25],
- b. Other financial instruments, generally as defined in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* [AC section F25], and
- c. Derivative commodity instruments, such as commodity futures, forwards, and swaps that are permitted by contract or custom to be settled in cash.

Collectively these instruments are referred to as "market-risk-sensitive instruments."

.14 In addition to qualitative (*i.e.*, descriptive) disclosures, Item 305 requires quantitative disclosures that may be presented in the form of a tabular presentation, sensitivity analysis, or value-at-risk disclosures. Disclosures generally include a combination of historical and fair value data and the hypothetical effects on such data of assumed changes in interest rates, foreign currency exchange rates, commodity prices and other relevant market rates. The quantitative and qualitative information required by Item 305 should be disclosed outside the financial statements and related notes thereto.

.15 *Question*—May an accountant provide positive or negative assurance on conformity with Item 305 of Regulation S-K?

.16 *Interpretation*—AS 6101.57 states that accountants may not give positive assurance on conformity of information with the disclosure requirements of Regulation S-K since this information is not in the form of financial statements and generally has not been audited by the accountants. Accountants may provide negative assurance on conformity with Regulation S-K only if the following conditions are met:

- a. The information is derived from the accounting records subject to the entity's controls over financial reporting, or has been derived directly from such accounting records by analysis or computation
- b. This information is capable of evaluation against reasonable criteria that have been established by the SEC.

Although some information needed to comply with Item 305 is derived from the accounting records, registrants must also provide a substantial amount of information that is not derived from accounting

records subject to the entity's controls over financial reporting. As a result, accountants should not provide negative assurance on conformity with Item 305 of Regulation S-K.

.17 *Question*—May an accountant otherwise provide comments in a comfort letter on items disclosed by registrants in accordance with Item 305 of Regulation S-K?

.18 *Interpretation*—AS 6101.55 states that accountants should comment only with respect to information—

- a. That is expressed in dollars (or percentages derived from such dollar amounts) and that has been obtained from accounting records that are subject to the entity's controls over financial reporting or
- b. That has been derived directly from such accounting records by analysis or computation.

As a result, accountants should not comment on the Item 305 qualitative disclosures.

.19 The three alternative forms of quantitative disclosures under Item 305 reflect hypothetical effects on market-risk-sensitive instruments and result in differing presentations. The forward-looking information used to prepare these presentations may be substantially removed from the accounting records that are subject to the entity's controls over financial reporting. Further, AS 6101.55 also states that "the accountants should not comment on matters merely because they happen to be present and are capable of reading, counting, measuring, or performing other functions that might be applicable." Accordingly, an accountant's ability to comment on these disclosures is largely dependent upon the degree to which the forward-looking information used to prepare these disclosures is linked to such accounting records.

.20 The tabular presentation includes the fair values of market-risk-sensitive instruments and contract terms to determine the future cash flows from those instruments that are categorized by expected maturity dates. This approach may require the use of yield curves and implied forward rates to determine expected maturity dates, as well as assumptions regarding prepayments and weighted average interest rates.

.21 The term *sensitivity analysis* describes a general class of models that are designed to assess the risk of loss in market-risk-sensitive instruments, based upon hypothetical changes in market rates or prices. Sensitivity analysis does not refer to any one, specific model and may include duration analysis or other "sensitivity" measures. The disclosures are dependent upon assumptions about theoretical future market conditions and, therefore, are not derived from the accounting records.

.22 The term *value at risk* describes a general class of models that provide a probabilistic assessment of the risk of loss in market-risk-sensitive instruments over a selected period of time, with a selected likelihood of occurrences based upon selected confidence intervals. Value-at-risk disclosures are extremely aggregated and, in addition to the assumptions made for sensitivity analyses, may include additional assumptions regarding correlation between asset classes and future market volatilities. As a result, these disclosures are not derived from the accounting records.

.23 Of the three disclosure alternatives, the tabular presentation contains the most limited number of

assumptions and least complex mathematical calculations. Furthermore, certain information, such as contractual terms, included in a tabular presentation is derived from the accounting records. Accordingly, accountants may perform limited procedures related to tabular presentations to the extent that such information is derived from the accounting records.

.24 The modeling techniques and underlying assumptions utilized for sensitivity analysis and value-at-risk disclosures generally will be highly complex. The resultant disclosures may be substantially different from the basic historical financial input derived directly from the accounting records. Due to the hypothetical and forward-looking nature of these disclosures and the potentially limited usefulness of any procedures that may be performed, accountants should not agree to make any comments or perform any procedures related to sensitivity analysis or value-at-risk disclosures.

.25 When performing procedures related to tabular presentation disclosures, the accountant will need to consider whether the entity's documentation of its contractual positions in derivatives, commodities and other financial instruments is subject to the entity's controls over financial reporting and whether it provides a complete record of the entity's market-risk-sensitive instruments. In addition, the accountant should disclaim as to the reasonableness of the assumptions underlying the disclosures.

.26 Item 305 requires registrants to stratify financial instruments according to market risk category, *i.e.*, interest rate risk, foreign exchange risk, and equity price risk. Item 305 stipulates that, if an instrument is at risk in more than one category, the instrument should be included in the disclosures for each applicable category. In reporting findings from agreed-upon procedures relating to market risk categories, the accountant should not provide any findings that the company's stratifications are complete or comply as to form with Item 305 requirements and should disclaim with respect to the company's determination of market risk categories.

.27 Item 305 encourages registrants to provide quantitative and qualitative information about market risk in terms of, among other things, the magnitude of actual past market movements and estimates of possible near-term market movements. Accountants should not agree to perform any procedures related to such market data.

.28 The accountant should establish a clear understanding with the underwriter as to the limitations of the procedures to be performed with respect to the market risk disclosures. Further, accountants should consider the need to utilize a specialist in performing procedures related to those disclosures.

.29 The following examples, based upon Example H of AS 6101.64, provide very simplified procedures, findings and limitations related to Item 305 tabular presentation disclosures. In practice, the procedures generally will be substantially more complex.

## Symbol

## Procedures and Findings

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Compared with a schedule prepared by the Company from its accounting records. We (a) compared the amounts on the schedule to corresponding amounts appearing in the accounting records and found such amounts to

be in agreement and (b) determined that the schedule was mathematically correct. However, we make no comment as to the appropriateness or completeness of the Company's classification of its market-risk-sensitive instruments into market risk categories, nor as to its determination of the expected maturity dates or amounts. (Note: This is an example of procedures related to tabular presentations of face amounts, carrying amounts, fair values and notional amounts which stratify such amounts as to interest rate risk.)

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Compared with a schedule prepared by the Company from its accounting records to calculate weighted average fixed interest rates and weighted average fixed pay and receive rates, and found such percentages to be in agreement. We (a) compared the amounts on the schedule to corresponding amounts appearing in the accounting records and found such amounts to be in agreement and (b) determined that the schedule was mathematically correct. However, we make no comment as to the appropriateness of the Company's methodology in calculating weighted average fixed rates.

(Note: It may be necessary to provide a more complete description of the procedures performed in other circumstances.)

We make no comment as to the appropriateness or completeness of the Company's determination of the Regulation S-K requirements for quantitative and qualitative disclosures about market risks or with respect to the reasonableness of the assumptions underlying the disclosures.

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*[The following is an extract from a registration statement that illustrates how an accountant can document procedures performed on a tabular presentation of market risk disclosures made in accordance with Item 305 of Regulation S-K.]*

## **Interest Rate Sensitivity**

The table below provides information about the Company's derivative financial instruments and other financial instruments that are sensitive to changes in interest rates, including interest rate swaps and debt obligations. For debt obligations, the table presents principal cash flows and related weighted average interest rates by expected maturity dates. For interest rate swaps, the table presents notional amounts and weighted average interest rates by expected maturity dates. Notional amounts are used to calculate the contractual payments to be exchanged under the contract. Weighted average variable rates are based on implied forward rates in the yield curve at the reporting date. The information is presented in U.S.

dollar equivalents, which is the Company's reporting currency. The instrument's actual cash flows are denominated in both U.S. dollars (\$US) and German deutschmarks (DM), as indicated in parentheses.

	Expected maturity dates						
	19X2 <sup>4</sup>	19X3 <sup>4</sup>	19X4 <sup>4</sup>	19X5 <sup>4</sup>	There- after <sup>4</sup>	Total	Fair Value
<i>Liabilities</i>							
Long-Term Debt:	(\$US equivalent in millions)						
Fixed Rate (\$US)	\$XXX	\$XXX	\$XXX	\$XXX	\$XXX	\$XXXÖ	\$XXXÖ
Average interest rate	XX%	XX%	XX%	XX%	XX%	XX%Ä	
Fixed Rate (DM)	XXX	XXX	XXX	XXX	XXX	XXXÖ	XXXÖ
Average interest rate	XX%	XX%	XX%	XX%	XX%	XX%Ä	
Variable Rate (\$US)	XXX	XXX	XXX	XXX	XXX	XXXÖ	XXXÖ
Average interest rate	XX%	XX%	XX%	XX%	XX%	XX% <sup>4</sup>	
Interest Rate Derivatives	(\$US equivalent in millions)						
<i>Interest Rate Swaps:</i>							
Variable to Fixed (\$US)	\$XXX	\$XXX	\$XXX	\$XXX	\$XXX	\$XXXÖ	\$XXXÖ

Average pay rate-fixed	XX%	XX%	XX%	XX%	XX%	XX% <sup>Ä</sup>	
Average receive rate-variable	XX%	XX%	XX%	XX%	XX%	XX% <sup>4</sup>	
Fixed to Variable (\$US)	XXX	XXX	XXX	XXX	XXX	XXX <sup>Ö</sup>	XXX <sup>Ö</sup>
Average pay rate-variable	XX%	XX%	XX%	XX%	XX%	XX% <sup>4</sup>	
Average receive rate-fixed	XX%	XX%	XX%	XX%	XX%	XX% <sup>Ä</sup>	

### Footnotes (AI 27 - Letters for Underwriters and Certain Other Requesting Parties: Auditing Interpretations of AS 6101):

<sup>1</sup> [Footnote deleted.]

<sup>2</sup> The auditor should not provide any assurance on compliance with the provisions of the Securities Exchange Act of 1934 regarding controls. See the guidance provided in AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*, paragraph .82.

<sup>3</sup> AS 6101.12 states in part: "Accountants will normally be willing to assist the underwriter but the assistance accountants can provide by way of comfort letters is subject to limitations. One limitation is that independent accountants can properly comment in their professional capacity only on matters to which his professional expertise is substantially relevant."

<sup>4</sup> No findings should be expressed on amounts in these columns because these disclosures include either management's expectations of future cash flows or the use of implied forward rates applied to such expected cash flows. Accordingly, such information does not meet the criteria of AS 6101.55.

## AI 28: Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations

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

[.01-.05] [Paragraphs deleted.]

### 2. The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals

.06 *Question*—The Internal Revenue Service's audit manual instructs its examiners on how to secure from corporate officials "tax accrual workpapers" or the "tax liability contingency analysis," including, "a memorandum discussing items reflected in the financial statements as income or expense where the ultimate tax treatment is unclear." The audit manual states that the examiner may question or summons a corporate officer or manager concerning the "knowledge of the items that make up the corporation's contingent reserve accounts." It also states that "in unusual circumstances, access may be had to the audit or tax workpapers" of an independent accountant or an accounting firm after attempting to obtain the information from the taxpayer. IRS policy also includes specific procedures to be followed in circumstances involving "Listed Transactions," to help address what the IRS considers to be abusive tax avoidance transactions (Internal Revenue Manual, section 4024.2-.5, 5/14/81, and Internal Revenue Service Announcement 2002-63, 6/17/02).

.07 Concern over IRS access to tax accrual working papers might cause some clients to not prepare or maintain appropriate documentation of the calculation or contents of the accrual for income taxes included in the financial statements, or to deny the independent auditor access to such information.

.08 What effect does this situation have on the auditor's opinion on the financial statements?

.09 *Interpretation*—The client is responsible for its tax accrual, the underlying support for the accrual, and the related disclosures. Limitations on the auditor's access to information considered necessary to audit the tax accrual will affect the auditor's ability to issue an unqualified opinion on the financial statements. Thus, if the client does not have appropriate documentation of the calculation or contents of the accrual for income taxes and denies the auditor access to client personnel responsible for making the

judgments and estimates relating to the accrual, the auditor should assess the importance of that inadequacy in the accounting records and the client imposed limitation on his or her ability to form an opinion on the financial statements. Also, if the client has appropriate documentation but denies the auditor access to it and to client personnel who possess the information, the auditor should assess the importance of the client-imposed scope limitation on his or her ability to form an opinion.

.10 Auditing standards require the auditor to obtain sufficient appropriate evidential matter through, among other things, inspection and inquiries to afford a reasonable basis for an opinion on the financial statements. Paragraph .35 of AS 2810, *Evaluating Audit Results*, requires the auditor to obtain sufficient appropriate evidential matter about assertions in the financial statements of material significance or else to qualify or disclaim his or her opinion on the statements. Paragraph .07 of AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, states that, "When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements." Also, AS 2805, *Management Representations*, requires the auditor to obtain written representations from management. AS 2805.06 states that specific representations should relate to the following matters, "availability of all financial records and related data," and AS 2805.08 states that a materiality limit does not apply to that representation. AS 2805.13 states that "management's refusal to furnish a written representation" constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.11 *Question*—A client may allow the auditor to inspect its tax accrual workpapers, but request that copies not be retained for audit documentation, particularly copies of the tax liability contingency analysis. The client also may suggest that the auditor not prepare and maintain similar documentation of his or her own. What should the auditor consider in deciding a response to such a request?

.12 *Interpretation*—Audit documentation is the written record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement. Audit documentation should include sufficient appropriate evidential matter to afford a reasonable basis for an opinion. In addition, audit documentation should be sufficient to enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of auditing procedures performed, and the evidence obtained. See AS 1215, *Audit Documentation*.

.13 The auditor's documentation of the results of auditing procedures directed at the tax accounts and related disclosures also should include sufficient appropriate evidential matter about the significant elements of the client's tax liability contingency analysis. This documentation should include copies of the client's documents, schedules, or analyses (or auditor-prepared summaries thereof) to enable the auditor to support his or her conclusions regarding the appropriateness of the client's accounting and disclosure of significant tax-related contingency matters. The audit documentation should reflect the procedures performed and conclusions reached by the auditor and, for significant matters, include the client's documentary support for its financial statement amounts and disclosures.

.14 The audit documentation should include the significant elements of the client's analysis of tax contingencies or reserves, including roll-forward of material changes to such reserves. In addition, the documentation should provide the client's position and support for income tax related disclosures, such as its effective tax rate reconciliation, and support for its intra-period allocation of income tax expense or



benefit to continuing operations and to items other than continuing operations. Where applicable, the documentation also should include the client's basis for assessing deferred tax assets and related valuation allowances and its support for applying the "indefinite reversal criteria" in APB Opinion No. 23, *Accounting for Income Taxes—Special Areas*, including its specific plans for reinvestment of undistributed foreign earnings.

.15 *Question*—In some situations, a client may furnish its outside legal counsel or in-house legal or tax counsel with information concerning the tax contingencies covered by the accrual for income taxes included in the financial statements and ask counsel to provide the auditor an opinion on the adequacy of the accrual for those contingencies.

.16 In such circumstances, rather than inspecting and obtaining documentary evidence of the client's tax liability contingency analysis and making inquiries of the client, may the auditor consider the counsel as a specialist and rely solely on counsel's opinion as an appropriate procedure for obtaining evidential matter to support his or her opinion on the financial statements?

.17 *Interpretation*—No. The opinion of legal counsel in this situation would not provide sufficient appropriate evidential matter to afford a reasonable basis for an opinion on the financial statements.

.18 The auditor's education, training, and experience enable him or her to be knowledgeable concerning income tax matters and competent to assess their presentation in the financial statements.

.19 The opinion of legal counsel on specific tax issues that he or she is asked to address and to which he or she has devoted substantive attention, as contemplated by AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, can be useful to the auditor in forming his or her own opinion. However, the audit of income tax accounts requires a combination of tax expertise and knowledge about the client's business that is accumulated during all aspects of an audit. Therefore, as stated above, it is not appropriate for the auditor to rely solely on such legal opinion.

.20 *Question*—A client may have obtained the advice or opinion of an outside tax adviser related to the tax accrual or matters affecting it, including tax contingencies, and further may attempt to limit the auditor's access to such advice or opinion, or limit the auditor's documentation of such advice or opinion. This limitation on the auditor's access may be proposed on the basis that such information is privileged. Can the auditor rely solely on the conclusions of third party tax advisers? What evidential matter should the auditor obtain and include in the audit documentation?

.21 *Interpretation*—As discussed in paragraphs .17 through .19 above, the auditor cannot accept a client's or a third party's analysis or opinion with respect to tax matters without careful consideration and application of the auditor's tax expertise and knowledge about the client's business. As a result of applying such knowledge to the facts, the auditor may encounter situations in which the auditor either disagrees with the position taken by the client, or its advisers, or does not have sufficient appropriate evidential matter to support his or her opinion.

.22 If the client's support for the tax accrual or matters affecting it, including tax contingencies, is based upon an opinion issued by an outside adviser with respect to a potentially material matter, the auditor should obtain access to the opinion, notwithstanding potential concerns regarding attorney-client

or other forms of privilege. The audit documentation should include either the actual advice or opinions rendered by an outside adviser, or other sufficient documentation or abstracts supporting both the transactions or facts addressed as well as the analysis and conclusions reached by the client and adviser. Alternatives such as redacted or modified opinions may be considered, but must nonetheless include sufficient content to articulate and document the client's position so that the auditor can formulate his or her conclusion. Similarly, it may be possible to accept a client's analysis summarizing an outside adviser's opinion, but the client's analysis must provide sufficient appropriate evidential matter for the auditor to formulate his or her conclusion. In addition, client representations may be obtained stating that the client has not received any advice or opinions that are contradictory to the client's support for the tax accrual.

.23 If the auditor is unable to accumulate sufficient appropriate evidence about whether there is a supported and reasonable basis for the client's position, the auditor should consider the effect of this scope limitation on his or her report.

[.24-.41] [Paragraphs deleted.]