

AU Section 9508

Reports on Audited Financial Statements: Auditing Interpretations of Section 508

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

.01 Question—Section 508, *Reports on Audited Financial Statements*, paragraph .24 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 audit evidence for inventories is discussed in section 331, *Inventories*, paragraphs .09–.12. Paragraph .09 of section 331 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 Section 331 paragraphs .10–.11 discuss 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 Section 331 paragraph .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 section 331 paragraphs .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.

[Issue Date: July 1975; Revised: October 2000; Revised: March 2006.]

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

[.07-.10] [Superseded by Statement on Auditing Standards (SAS) No. 15, effective for periods ending after June 30, 1977.]

[3.] Reporting on Loss Contingencies

[.11-.14] [Superseded by SAS No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

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

[.15-.20] [Superseded December 31, 1980, by SAS No. 29, as superseded by SAS Nos. 118 and 119.]

[5.] Disclosures of Subsequent Events

[.21-.24] [Superseded by SAS No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

[6.] The Materiality of Uncertainties

[.25-.28] [Superseded by SAS No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

[7.] Reporting on an Uncertainty

[.29-.32] [Withdrawn, August 1982, by SAS No. 43.]

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

.33 *Question*—Footnote †† of Statement of Position (SOP) 93-3, *Rescission of Accounting Principles Board Statements* (AICPA, *Technical Practice Aids*, ACC sec. 10,560), 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 GAAP 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 GAAP 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 Examples of auditor's reports with such an explanatory paragraph follow.

Report on Single Year Financial Statements in Year of Adoption of Liquidation Basis

"We have audited the statement of net assets in liquidation of XYZ Company as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2. In addition, we have audited the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

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

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

Report on Comparative Financial Statements in Year of Adoption of Liquidation Basis

"We have audited the balance sheet of XYZ Company as of December 31, 20X1, the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2. In addition, we have audited the statement of net assets in liquidation as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

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

.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 to reflect conforming changes necessary due to the issuance of SAS No. 79.]

[Issue Date: December 1984; Revised: June 1993; Revised: February 1997;
Revised: October 2000; Revised: June 2009.]

[9.] Quantifying Departures From Generally Accepted Accounting Principles

[.39–.43] [Superseded by SAS No. 58, effective for reports issued or reissued on or after January 1, 1989.] (See section 508.)

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

[.44–.48] [Withdrawn, March 1989, by the Auditing Standards Board (ASB).]

[11.] Restating Financial Statements Reported on by a Predecessor Auditor

[.49–.50] [Superseded by SAS No. 84, effective with respect to acceptance of an engagement after March 31, 1998.] (See section 315, *Communications Between Predecessor and Successor Auditors*.)

12. Reference in Auditor's Standard Report to Management's Report

.51 Question—One of the basic elements of the auditor's standard 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 section 508, *Reports on Audited Financial Statements*, should not be further elaborated upon in the auditor's standard report or referenced to management's report. Such modifications to the standard auditor's 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.

[Issue Date: January 1989.]

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

[.53–.55] [Withdrawn October 2000 by SAS No. 93.]

14. Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing

.56 Question—Section 508 states that a basic element of the auditor's report is a statement that the audit was conducted in accordance with generally accepted auditing standards (GAAS) and an identification of the United States of America as the country of origin of those standards. If the auditor conducts the audit in accordance with standards generally accepted in the United States of America and in accordance with the International Standards on Auditing (ISA) promulgated by the International Auditing and Assurance Standards Board (IAASB), may the auditor so indicate in the auditor's report?

.57 Interpretation—Yes. Section 508 requires that the auditor indicate in the auditor's report that the audit was conducted in accordance with GAAS and an identification of the United States of America as the country of origin of those standards; however, section 508 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 ISAs, in their entirety, the auditor may so indicate in the auditor's report. To determine whether an audit was conducted in accordance with the ISAs, it is necessary to consider the text of the ISA in their entirety, including the basic

principles and essential procedures together with the related guidance included in the ISA.^[1]

.58 When reporting on an audit performed in accordance with auditing standards generally accepted in the United States of America and ISA, the auditor should comply with reporting standards generally accepted in the United States of America.

.59 An example of reporting on an audit conducted in accordance with auditing standards generally accepted in the United States and in accordance with ISA follows:

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and in accordance with International Standards on Auditing. 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.

[Issue Date: March 2002; Revised: May 2008.]

15. Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations²

.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 section 508 paragraph .74, the successor auditor should indicate in the introductory paragraph 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 a standard report, the substantive reasons therefor. The successor auditor ordinarily also should indicate that the other auditor has ceased operations. Footnote 29 of section 508 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 introductory paragraph 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

^[1] [Footnote deleted, November 2010, due to the removal of AU appendix B.]

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 nonpublic entities.

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, 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 section 508 paragraph .74. (The auditor also may use the guidance on alternative language contained in paragraph .71.) 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 section 561, *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.³

.66 The successor auditor should refer to the predecessor auditor's report in his or her report, as described in paragraph .61, 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.⁴

³ See Securities and Exchange Commission (SEC) 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 section 315, *Communications Between Predecessor and Successor Auditors*. Section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, 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.

.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.⁵

.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 section 508 paragraph .74. 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.

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.

.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] [Paragraph deleted due to the passage of time, June 2009.]

.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 section 508 paragraph .74?

.75 Interpretation—No. Section 508 paragraph .74 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.

[Issue Date: November 2002; Revised: June 2009.]

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 Question—Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 946, *Financial Services—Investment Companies*, addresses financial statement presentation and disclosure requirements for investment partnerships that are exempt from SEC registration under the Investment Company Act of 1940 (the 1940 act). FASB ASC 946-210-50 specifically describes information that should be disclosed in a Schedule of Investments. FASB ASC 946-210-50-6 states that the financial statements of an investment partnership that is exempt from SEC registration under the Investment Company Act of 1940, should, at a minimum, include a condensed schedule of investments in securities owned by the partnership at the close of the most recent period. Such a schedule shall do all of the following:

- a. Categorize investments by all of the following:

The Fourth Standard of Reporting

- (1) Type (such as common stocks, preferred stocks, convertible securities, fixed-income securities, government securities, options purchased, options written, warrants, futures, loan participations, short sales, other investment companies, and so forth)
 - (2) Country or geographic region, except for derivative instruments for which the underlying is not a security (see [a][4])
 - (3) Industry, except for derivative instruments for which the underlying is not a security (see [a][4])
 - (4) For derivative instruments for which the underlying is not a security, by broad category of underlying (for example, grains and feeds, fibers and textiles, foreign currency, or equity indexes) in place of the categories in (a)(2) and (a)(3)
- b. Report the percent of net assets that each such category represents and the total value and cost for each category in (a)(1) and (a)(2)
- c. Disclose the name, shares or principal amount, value, and type of both of the following:
- (1) Each investment (including short sales) constituting more than 5 percent of net assets, except for derivative instruments (see [e]); in applying the 5 percent test, total long and total short positions in any one issuer should be considered separately
 - (2) All investments in any one issuer aggregating more than 5 percent of net assets, except for derivative instruments (see [e]); in applying the 5 percent test, total long and total short positions in any one issuer shall be considered separately
- d. Aggregate other investments (each of which is 5 percent or less of net assets) without specifically identifying the issuers of such investments, and categorize them in accordance with the guidance in (a); in applying the 5 percent test, total long and total short positions in any one issuer shall be considered separately
- e. Disclose the number of contracts, range of expiration dates, and cumulative appreciation (depreciation) for open futures contracts of a particular underlying (such as wheat, cotton, specified equity index, or U.S. Treasury Bonds), regardless of exchange, delivery location, or delivery date, if cumulative appreciation (depreciation) on the open contracts exceeds 5 percent of net assets; in applying the 5 percent test, total long and total short positions in any one issuer shall be considered separately
- f. Disclose the range of expiration dates and fair value for all other derivative instruments of a particular underlying (such as foreign currency, wheat, specified equity index, or U.S. Treasury Bonds) regardless of counterparty, exchange, or delivery date, if fair value exceeds 5 percent of net assets; in applying the 5 percent test, total long and total short positions in any one issuer shall be considered separately
- g. Provide both of the following additional qualitative descriptions for each investment in another nonregistered investment partnership whose fair value constitutes more than 5 percent of net assets:
- (1) The investment objective
 - (2) Restrictions on redemption (that is, liquidity provisions)

.77 Section 508 paragraph .41 addresses the effect of inadequate disclosure of information essential for fair presentation of the financial statements on the auditor's report. It states:

If the financial statements, including accompanying notes, fail to disclose information that is required by GAAP, the auditor should express a qualified or adverse opinion because of the departure from those principles and should provide the information in the report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific SAS.

.78 Section 508 paragraph .42 provides an example of a report qualified for inadequate disclosure (assuming that the auditor has concluded that it is not practicable to present the required information and the effects are such that the auditor has concluded an adverse opinion is not appropriate) as follows:

Independent Auditor's Report

[Same first and second paragraphs as the standard report]

The Company's financial statements do not disclose *[describe the nature of the omitted information that it is not practicable to present in the auditor's report]*. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

In our opinion, except for the omission of the information discussed in the preceding paragraph, . . .

.79 FASB ASC 946 does not make it clear how the guidance in section 508 paragraphs .41–.42 should be applied to reports on financial statements of investment partnerships that are exempt from SEC registration and that do not include all the investment information required in the Schedule of Investments as required by FASB ASC 946. For example, if the financial statements did not disclose each of the required items for each investment, the guidance in section 508 paragraph .41 indicates the auditor should, if practicable, include the missing information (for example, the Schedule of Investments or information about individual investments) in the auditor's report. However, the example in section 508 paragraph .42 provides that the auditor would disclose the nature of the missing information, rather than the actual information, in the auditor's report.

.80 In applying section 508 paragraphs .41–.42 to an auditor's report on financial statements of an investment partnership that is exempt from SEC registration and that does not include the required Schedule of Investments information required by FASB ASC 946-210-50-6, is it sufficient for the auditor to describe "the nature of the omitted disclosures" in his or her report expressing a qualified (or adverse) opinion?

.81 *Interpretation*—No. The example in section 508 paragraph .42 does not change the requirement in section 508 paragraph .41 for the auditor to issue a qualified or adverse opinion and also to provide the missing information, if practicable. If the investment disclosures required by FASB ASC 946 are not included in the financial statements and it is practicable for the auditor to determine them or any portion thereof, the auditor should include the information in his or her report expressing the qualified or adverse opinion.

.82 Footnote 15 of section 508 indicates that it is practicable to provide the missing information if "the information is reasonably obtainable from management's accounts and records and . . . providing the information in the report does not require the auditor to assume the position of a preparer of financial information." Ordinarily, it would be practicable for the auditor to obtain and present the information about investments constituting more than 5 percent

of net assets called for by section (b) of the disclosure requirement described in paragraph .76. However, due to the need to categorize the investments for the purpose of preparing the schedule called for by section (a) of the disclosure requirement described in paragraph .76, the auditor might be in the position of preparer of financial information and, therefore, would not include the schedule in his or her report. In rare cases, the Schedule of Investments information may be so limited that the auditor may conclude that disclosure of the entire schedule is practicable.

.83 Following is an illustration of a report that expresses a qualified opinion because the Schedule of Investments fails to disclose investments constituting more than 5 percent of net assets, but in all other respects conforms to the requirements of FASB ASC 946:

Independent Auditor's Report

[Same first and second paragraphs as the standard report]

The Schedule of Investments included in the Partnership's financial statements does not disclose required information about the following investments, each constituting more than 5 percent of the Partnership's total net assets, at December 31, 20X2:

- Amalgamated Buggy Whips, Inc., 10,000 shares of common stock—fair value \$3,280,000 (Consumer nondurable goods)
- Paper Airplane Corp., 6.25% Cv. Deb. due 20XX, \$4.5 million par value—fair value \$4,875,000 (Aviation)

In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements and financial highlights referred to above present fairly, . . .

.84 An illustration of an adverse opinion relating to failure to present the entire Schedule of Investments and all of the related required information follows.⁶ This illustration assumes that the auditor has concluded that it is not practicable to present all of the required information. In such circumstances, the auditor presents in his or her report the missing information, where it is practicable to do so, and describes the nature of the missing information where it is not practicable to present the information in the report:

Independent Auditor's Report

[Same first and second paragraphs as the standard report]

The Partnership has declined to prepare and present a Schedule of Investments and the related information as of December 31, 20X2. Accounting principles generally accepted in the United States of America require presentation of this Schedule and the related information. Presentation of this Schedule would have disclosed required information about the following investments, each constituting more than 5 percent of the Partnership's total net assets, at December 31, 20X2:

- Amalgamated Buggy Whips, Inc., 10,000 shares of common stock—fair value \$3,280,000 (Consumer nondurable goods)⁷

⁶ Section 508 paragraph .36 discusses the factors the auditor considers in deciding whether to issue a qualified opinion or an adverse opinion.

⁷ In the absence of a Schedule of Investments containing categorizations by type, country or geographic region, and industry, such categorizations should be provided only if readily ascertainable from management's accounts and records. The auditor should not assign such categorizations if management has not done so.

- Paper Airplane Corp., 6.25% Cv. Deb. due 20XX, \$4.5 million par value—fair value \$4,875,000 (Aviation)

In addition, presentation of the Schedule of Investments would have disclosed [describe the nature of the information that it is not practicable to present in the auditor's report].

In our opinion, because the omission of a Schedule of Investments results in an incomplete presentation as explained in the preceding paragraph, the financial statements and financial highlights referred to above do not present fairly, . . .

[Issue Date: April 9, 2003; Revised: June 2009.]

17. Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards

.85 Question—Auditing standards established by the ASB of the AICPA are in effect and are enforceable⁸ for audits of entities that are not *issuers*, as that term is defined by the Sarbanes-Oxley Act of 2002 (the act) or whose audit is not prescribed by the rules of the SEC. For purposes of this interpretation, these entities are referred to as *nonissuers*.⁹

.86 Section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, provides guidance on the auditor's consideration of internal control in an audit of a nonissuer's financial statements in accordance with GAAS. That consideration is intended to provide the auditor a sufficient understanding of internal control to plan the audit and to determine the nature, timing, and extent of tests to be performed. The scope of the auditor's procedures required under section 314 is considerably less than that required for an attestation of internal control pursuant to Section 404(b) of the act.

.87 To clarify that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer when Section 404(b) of the act is applicable, may the auditor expand his or her audit report to indicate that the purpose and extent of the auditor's testing of internal control over financial reporting was to determine the auditor's procedures and was not sufficient to express an opinion on the effectiveness of internal control over financial reporting?

⁸ The AICPA governing council designated the Public Company Accounting Oversight Board (PCAOB) as the body, pursuant to Rule 201, *General Standards* (ET sec. 201 par. .01), and Rule 202, *Compliance With Standards* (ET sec. 202 par. .01) of the AICPA's Code of Professional Conduct, with the authority to promulgate auditing and related attestation standards, quality control, ethics, independence and other standards relating to the preparation and issuance of audit reports for issuers, as defined by the Sarbanes-Oxley Act of 2002. The council also designated the Auditing Standards Board (ASB), pursuant to Rules 201 and 202 (ET sec. 201 par. .01 and ET sec. 202 par. .01), as the body with the authority to promulgate auditing, attestation, and quality control standards and procedures for all other entities.

⁹ In a report issued on the audit of the financial statements of a subsidiary, investee, or other type of affiliate of an issuer, that is not itself an issuer, the auditor should refer to the audit as having been performed in accordance with generally accepted auditing standards (GAAS) if the report will not be filed with the SEC. For example, a subsidiary of an issuer may be subject to certain regulations that require an audit be performed in accordance with *Government Auditing Standards* (the Yellow Book). In this example, the auditor's report of the nonissuer should refer to GAAS and generally accepted government auditing standards.

.88 Interpretation—Yes. An auditor may add such language to the auditor's standard report. An example of additional language¹⁰ that may be included in the auditor's report to indicate this matter follows:

Independent Auditor's Report

[Same first paragraph as the standard report]

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. *An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.* An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

[Same opinion paragraph as the standard report]

[Issue Date: June 2004; Revised: March 2006.]

18. Reference to PCAOB Standards in an Audit Report on a Nonissuer¹¹

.89 Question—Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, PCAOB Standards and Related Rules, Auditing Standards), directs auditors to state in the auditor's report that the engagement was conducted in accordance with "the standards of the Public Company Accounting Oversight Board (United States)" whenever the auditor has performed the engagement in accordance with Public Company Accounting Oversight Board (PCAOB) standards. Additionally, the release accompanying the standard states that "nothing in the Board's rules would preclude an accounting firm from conducting an audit of a company that is not an issuer in accordance with the Board's standards and so stating in its audit report. This is true regardless of whether or not the accounting firm performing the audit is registered with the Board."

.90 If an auditor is engaged to perform an audit of a nonissuer in accordance with PCAOB standards, which standards are applicable and how should the auditor report?

.91 Interpretation—Section 508 requires the auditor to indicate in the auditor's report that the audit was conducted in accordance with GAAS and an identification of the United States of America as the country of origin of those standards. However, an auditor may indicate that the audit was also conducted in accordance with another set of auditing standards. If the auditor conducted

¹⁰ The additional language related to internal control should not be used when reporting on the audit of financial statements of a nonissuer that engages its auditor to examine (or audit) and report on the effectiveness of internal control over financial reporting either voluntarily or to comply with regulatory requirements.

¹¹ In a report issued on the audit of the financial statements of a subsidiary, investee, or other type of affiliate of an issuer, that is not itself an issuer, the auditor should refer to the audit as having been performed in accordance with GAAS if the report will not be filed with the SEC. For example, a subsidiary of an issuer may be subject to certain regulations that require an audit be performed in accordance with *Government Auditing Standards* (the Yellow Book). In this example, the auditor's report of the nonissuer should refer to GAAS and generally accepted government auditing standards.

the audit in accordance with GAAS *and* the auditing standards of the PCAOB, the auditor may indicate in the auditor's report that the audit was conducted in accordance with both sets of standards.

.92 Following is an example of additional language that may be included ¹² in the auditor's report to indicate that an audit was conducted in accordance with both GAAS and the PCAOB's auditing standards, and to clarify that the purpose and extent of the auditor's testing of internal control over financial reporting was to determine the auditor's procedures and was not sufficient to express an opinion on the effectiveness of internal control. To clarify the source of GAAS in a dual reference reporting situation, the auditor may indicate that the audit was conducted in accordance with GAAS as established by the ASB:

Independent Auditor's Report

[Same first paragraph as the standard report]

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

[Same opinion paragraph as the standard report]

[Issue Date: June 2004.]

19. Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board

.93 Question—Section 508 provides guidance regarding auditors' reports issued in connection with audits of historical financial statements prepared in conformity with GAAP. May an independent auditor apply the guidance in section 508 when engaged to report on financial statements presented in conformity with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB)?

¹² This example includes the illustrative language from paragraph .88. Because the PCAOB's Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), requires an audit of internal control for certain entities that are subject to Section 404(a) of the act, an audit of a nonissuer performed under PCAOB auditing standards does not require an audit of internal control unless otherwise required by a regulator with jurisdiction over the nonissuer. The additional language related to internal control should not be used when reporting on the audit of financial statements of a nonissuer that engages its auditor to examine (or audit) and report on the effectiveness of internal control over financial reporting either voluntarily or to comply with regulatory requirements.

.94 Interpretation—Yes. Because the IASB has been designated by the council of the AICPA as the body to establish international financial reporting standards for both private and public entities pursuant to Rule 202 (ET sec. 202 par. .01) and Rule 203, *Accounting Principles* (ET sec. 203 par. .01), of the AICPA Code of Professional Conduct and as of May 18, 2008, an auditor may report on general purpose financial statements presented in conformity with IFRS as issued by the IASB. When the auditor reports on financial statements prepared in conformity with IFRS, the auditor would refer, in the auditor's report, to IFRS rather than U.S. GAAP.

.95 An example of the opinion paragraph follows:

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Entity as of [at] December 31, 20X2 and 20X1, and the results of its operations, comprehensive income, changes in equity and its cash flows for the years then ended in conformity with International Financial Reporting Standards as issued by the International Accounting Standards Board.

.96 An entity may prepare financial statements in conformity with a jurisdictional variation of IFRS such that the entity's financial statements do not contain an explicit and unreserved statement of compliance with IFRS as issued by the IASB. Because the council of the AICPA has not designated bodies other than the IASB to establish international financial reporting standards, section 534, *Reporting on Financial Statements Prepared for Use in Other Countries*, applies to such financial statements prepared for use outside the United States, and paragraphs .14–.15 of section 534 and paragraphs .35–.60 of section 508 apply to financial statements prepared for more than limited distribution in the United States.

.97 If financial statements are presented in conformity with both IFRS as issued by the IASB and a jurisdictional variation of IFRS (for example, financial statements prepared in conformity with IFRS as issued by the IASB and with IFRS as endorsed by the European Union), an auditor may follow the guidance as described above.

[Issue Date: May 2008.]
