

AU Section 9623

Special Reports: Auditing Interpretations of Section 623

[1.] Auditor's Report Under Employee Retirement Income Security Act of 1974

[.01–.08] [Withdrawn February 1983.]

[2.] Reports on Elements, Accounts, or Items of a Financial Statement That Are Presented in Conformity with GAAP

[.09–.10] [Withdrawn March 1989, by SAS No. 62.] (See section 623.)

[3.] Compliance With the Foreign Corrupt Practices Act of 1977

[.11–.14] [Transferred to section 9642; Deleted October 1993.] [Revised, January 2001, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 10; Revised, January 2009, to reflect conforming changes necessary due to the issuance of Statement on Standards for Attestation Engagements No. 15.]

[4.] Reports on Engagements Solely to Meet State Regulatory Examination Requirements

[.15–.16] [Deleted April 1981 by SAS No. 35, as superseded by SAS No. 75, as superseded by SAS No. 93.] (See section 622.) [Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

[5.] Financial Statements Prepared in Accordance with Accounting Practices Specified in an Agreement

[.17–.25] [Withdrawn March 1989 by SAS No. 62.] (See section 623.)

[6.] Reporting on Special-Purpose Financial Presentations^[3–4]

[.26–.31] [Withdrawn March 1989 by SAS No. 62.] (See section 623.)

[7.] Understanding of Agreed-Upon Procedures

[.32–.33] [Deleted April 1981 by SAS No. 35, as superseded by SAS No. 75, as superseded by SAS No. 93.] (See section 622.) [Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

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

[.34–.39] [Withdrawn March 1989 by SAS No. 62.] (See section 623.)

^[3–4] [Footnote 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 generally accepted auditing standards 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—Section 623 paragraphs .11–.18 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.⁵

Illustrative report

Board of Directors

X Insurance Company

We are members of the American Institute of Certified Public Accountants (AICPA) and are the independent public accountants of X Insurance Company. We acknowledge our responsibility under the AICPA's Code of Professional Conduct to undertake only those engagements which we can complete with professional competence.

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.

⁵ 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.

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
Date

X Insurance Company
Schedule of Liabilities for Losses
and Loss Adjustment Expenses
December 31, 19X0

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

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 Question—The instructions to the statutory annual statement also include the following:

If there has been any material change in the assumptions and/or methods from those previously employed, that change should be described in the statement of opinion by inserting a phrase such as:

A material change in assumptions (and/or methods) was made during the past year, but such change accords with accepted loss reserving standards.

A brief description of the change should follow.

.44 In what circumstances is it appropriate for the independent auditor to modify his special report on loss and loss adjustment expense reserves for material changes in assumptions and/or methods?

.45 Interpretation—Section 420 paragraph .06 states that changes in accounting principles and methods of applying them affect consistency and require the addition of an explanatory paragraph (following the opinion paragraph) in the auditor's report on the audited financial statements. Section 623 paragraph .16 states that, if applicable, any departures from the auditor's standard report on the related financial statements should be indicated in the special report on an element, account, or item of a financial statement.

.46 Section 420 paragraph .16 states that a change in accounting estimate is not a change affecting consistency requiring recognition in the auditor's report. However, such changes in estimates that are disclosed in the financial statements on which the auditor has reported should also be disclosed in the notes to the schedule of liabilities for unpaid losses and unpaid loss adjustment expenses accompanying the auditor's special report. (See Financial Accounting Standards Board (FASB) *Accounting Standards Codification (ASC)* 250-10-50-4.)

[Issue Date: May 1981; Revised: February 1999; Revised: October 2000; Revised: June 2009.]

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 report⁶ are presented fairly in conformity with generally accepted accounting principles. Ordinarily, financial statements included in a Form 990 used by a charitable organization as a uniform annual report may be expected to contain certain material departures from the accounting principles in FASB ASC 954, *Health Care Entities*, and FASB ASC 958, *Not-for-Profit Entities*.

.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 section 623, *Special Reports*, paragraph .08, for reporting on financial statements prepared in accordance with the requirements or financial reporting provisions of a government regulatory agency).

.51 Section 623 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.

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

However, section 623 makes this form of reporting appropriate, even though by law or regulation the accountant's report may be made a matter of public record.⁷

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

Independent Auditor's Report

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 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, 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.^[8]

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]

[Date]

⁷ *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.]

.53 If there is public distribution⁹ 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 section 623 paragraph .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 to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 87.]

[Issue Date: December 1991; Revised: February 1997;
Revised: February 1999; Revised: October 2000; Revised: June 2009.]

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 statements¹⁰ 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 section 623, *Special Reports*, paragraph .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.

⁹ 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 section 508, *Reports on Audited Financial Statements*, and applicable industry guidance. [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.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:

Independent Auditor's Report

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

In our opinion, the 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]

[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.

[Issue Date: July 1990; Revised: February 1999; Revised: October 2000.]

12. Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis¹¹

.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?¹² [As amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

.61 Interpretation—Financial statements prepared on a statutory basis are financial statements prepared on a comprehensive basis of accounting other than GAAP according to section 623, *Special Reports*, paragraph .04. Section 623 paragraph .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 he or she does to financial statements prepared in conformity with generally accepted accounting principles. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation. [Title of section 411 amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Standards No. 93. As amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning

¹¹ Interpretation No. 14, "Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)" (paragraphs .90–.95), provides interpretive guidance applicable to all OCBOA presentations. This interpretation provides additional guidance regarding the appropriateness of informative disclosures in insurance enterprises' financial statements prepared on a statutory basis. [Footnote added by the revision of Interpretations No. 12 and No. 14, January 2005.]

¹² 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. [Footnote added, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5. Footnote renumbered by the revision of Interpretations No. 12 and No. 14, January 2005.]

on or after that date and audits of those financial statements, by Statement of Position 01-5. Revised, October 2009, to reflect conforming changes necessary due to the withdrawal of SAS No. 69.]

.62 Section 623 paragraph .02 states that generally accepted auditing standards apply when an auditor conducts an audit of and reports on financial statements prepared on an other comprehensive basis of accounting. Thus, in accordance with the third standard of reporting, "When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the report."

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

.64 Interpretation—Section 623 paragraph .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. The provisions of the preamble of the revised Manual that states, "GAAP pronouncements do not become part of Statutory Accounting Principles until and unless adopted by the NAIC," do not negate the requirements of section 623 paragraph .10, which 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." [As amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

[.65–.66] [Paragraphs deleted by the issuance of Statement of Position 01-5, December 2001.]

.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?

[As amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

.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.¹³ Disclosures

¹³ The provisions of the preamble of the revised Manual that states, "GAAP pronouncements do not become part of Statutory Accounting Principles until and unless adopted by the NAIC" or any other explicit rejection of a GAAP disclosure does not negate the requirements of section 623 paragraph .10. [Footnote added by the revision of Interpretations No. 12 and No. 14, January 2005.]

should also include those required by the revised Manual. [As amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

[.69] [Paragraph deleted by the issuance of Statement of Position 01-5, December 2001.]

.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. [As amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

.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. [As amended, effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements, by Statement of Position 01-5.]

[.72-.76] [Paragraphs deleted by the issuance of Statement of Position 01-5, December 2001.]

.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 to reflect conforming changes necessary due to the issuance of FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, and FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*.]

[.80-.81] [Paragraphs deleted by the revision of Interpretation Nos. 12 and 14, January 2005.]

[Issue Date: December 1991; Revised: February 1997; Amended: December 2001; Revised: January 2005; Revised: November 2006.]

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. Section 623, *Special Reports*, paragraph .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? [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.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 section 508, *Reports on Audited Financial Statements*, paragraphs .35-.44 and .58-.60. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.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? [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.85 Interpretation—Yes. In such cases, the auditor should follow the guidance in section 623 paragraphs .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 section 508 paragraphs .35-.44 and .58-.60. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

[.87-.89] [Paragraphs deleted to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 87. Paragraphs renumbered by the issuance of Statement of Position 01-5, December 2001.]

[Issue Date: May 1995; Revised: February 1999.]

14. Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)¹⁴

.90 Question—Section 623, *Special Reports*, paragraph .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, section 623 paragraphs .10

¹⁴ While this interpretation provides guidance applicable to all OCBOA presentations, Interpretation No. 12 (paragraphs .60-.81) provides additional interpretive guidance regarding the appropriateness of informative disclosures in insurance enterprises' financial statements prepared on a statutory basis. [Footnote added by the revision of Interpretations No. 12 and No. 14, January 2005.]

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 section 623 paragraph .10 be applied in evaluating the adequacy of disclosure in financial statements prepared in conformity with an other comprehensive basis of accounting (OCBOA)? [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.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. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.92 If OCBOA 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 ASC 320, *Investments—Debt and Equity Securities*, 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 ASC 715, *Compensation—Retirement Benefits*, 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.

[Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.93 If GAAP sets forth requirements that apply to the presentation of financial statements, the OCBOA financial 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.

[Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.94 Presentations using OCBOA 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, 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. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.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 FASB ASC 275, *Risks and Uncertainties*, would not be relevant in a presentation that has no estimates, such as one based on cash receipts and disbursements. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

[Issue Date: January 1998; Revised: January 2005; Revised: June 2009.]

15. Auditor Reports on Regulatory Accounting or Presentation When the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request

.96 Question—Occasionally, certain state and local governmental entities, as well as other regulated entities, prepare their financial statements in conformity with the requirements or financial reporting provisions of a governmental regulatory agency. If the financial statements and report are intended for use by parties other than those within the entity and one or more regulatory agencies to whose jurisdiction the entity is subject or the financial statements and report are distributed by the entity to parties other than the regulatory agencies to whose jurisdiction the entity is subject, either voluntarily or upon specific request, what report should the auditor issue?

.97 Interpretation—Section 623.05f, footnote 4, states in part that the auditor is precluded from using the form of report set forth in section 623 "in circumstances in which the entity distributes the financial statements to parties other than the regulatory agency either voluntarily or upon specific request." Footnote 5 states further that the auditor should follow the guidance in section 544, *Lack of Conformity With Generally Accepted Accounting Principles*, if the financial statements and report are intended for use by parties other than those within the entity and one or more regulatory agencies to whose jurisdiction the entity is subject. Section 544 paragraph .04, in turn, states in those circumstances [referring to circumstances in which the financial statements and reports will be used by parties or distributed by the entity to parties other than the regulatory agencies to whose jurisdiction the entity is subject] the auditor should use the standard form of report modified as appropriate because of the departures from generally accepted accounting principles and then in an additional paragraph express an opinion on whether the financial statements are presented in conformity with the regulatory basis of accounting.

The following is an illustration of a report prepared on a regulatory basis of accounting prescribed by a regulatory agency, to whose jurisdiction an entity is subject, that requires a presentation of cash and unencumbered cash, cash receipts and disbursements, and budgetary comparisons and the financial statements are not prepared solely for filing with that agency:

Independent Auditor's Report

We have audited the accompanying statement of cash and unencumbered cash; cash receipts and disbursements; and disbursements—budget and actual for each fund of City of Example, Any State, as of and for the year ended June 30, 20XX. These financial statements are the responsibility of City's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As described more fully in Note X, City has prepared these financial statements using accounting practices prescribed or permitted by [name of regulatory agency], which practices differ from accounting principles generally accepted in the United States of America. The effects on the financial statements of the variances between these regulatory accounting practices and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of each fund of City as of June 30, 20XX, or changes in financial position or cash flows¹⁵ thereof for the year then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the cash and unencumbered cash balances of each fund of City as of June 30, 20XX, and their respective cash receipts and disbursements, and budgetary results for the year then ended, on the basis of accounting described in Note X.

[Signature]

[Date]

.98 If the auditor issues a report in accordance with section 623 paragraph .05(f), nothing precludes the auditor, in connection with establishing the terms of the engagement, from reaching an understanding with the client that the intended use of the report will be restricted, and from obtaining the client's agreement that the client and the specified parties will not distribute the report to parties other than those identified in the report.

[Issue Date: January 2005.]

¹⁵ Reference to cash flows would not be needed if the entity, under generally accepted accounting principles, is not required to present a statement of cash flows.