

**FINANCIAL SERVICES COMMISSION**  
**Office of Insurance Regulation**  
**Materials Available on the Web at:**  
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**December 4, 2018**

**MEMBERS**

Governor Rick Scott  
Attorney General Pam Bondi  
Chief Financial Officer Jimmy Patronis  
Commissioner Adam Putnam

**Contact:**      **Caitlin Murray**  
                      **(850-413-5005)**

8:00 A.M.  
LL-03, The Capitol  
Tallahassee, Florida

<b>ITEM</b>	<b>SUBJECT</b>	<b>RECOMMENDATION</b>
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1. Request for Approval of Minutes of the Financial Services Commission for June 13, 2018.

<http://www.myflorida.com/myflorida/cabinet/agenda18/0613/transcript.pdf>

**(ATTACHMENT 1)**

**FOR APPROVAL**

2. Request for Approval for Publication of Repeal of Rules 69O-203.204,.205; Filing Approval of DMPO Plans, Rates and Related Forms; Bundled Products

The rules are being repealed to conform to the statutory changes, implemented by Chapter 2017-112, Laws of Florida. These rules are obsolete.

**(ATTACHMENT 2)**

**APPROVAL FOR PUBLICATION**

3. Request for Approval for Publication of Rules 69O-203.201,.202,.203,.210; Definitions; Standards for Discount Medical Plans; Standards for the Form and Content of Advertisements or Marketing Materials; Forms Incorporated by Reference

The rules will be updated to conform to the statutory changes, implemented by Chapter 2017-112, Laws of Florida, renaming "discount medical plan organizations" to "discount plan organizations" and revising conditions for reimbursement, disclosure requirements, reporting requirements, fee requirements, marketing requirements, and the authority for the Financial Services Commission to adopt rules.

**(ATTACHMENT 3)**

**APPROVAL FOR PUBLICATION**

4. Request for Approval for Publication of Rules 69O-238.001,.002; Application; Change in Information

The Office of Insurance Regulation is developing new rules to implement Ch. 2018-91, Laws of Florida, signed into law on March 23, 2018. The legislation requires the Financial Services Commission to implement some of its provisions by rule.

**(ATTACHMENT 4)**

**APPROVAL FOR PUBLICATION**

5. Request for Approval for Publication of Rules 69O-137.001; Annual and Quarterly Reporting Requirements

The amendments incorporate by reference new editions of the NAIC's Annual Statement Instructions, the NAIC's Quarterly Statement Instructions, and the NAIC's Accounting Practices and Procedures Manual.

**(ATTACHMENT 5)**

**APPROVAL FOR PUBLICATION**

6. Request for Approval for Final Adoption of Rule 69O-138.001; NAIC Financial Condition Examiners Handbook Adopted

The amendments incorporate by reference new editions of the NAIC Financial Condition Examiners Handbooks.

**(ATTACHMENT 6)**

**APPROVAL FOR PUBLICATION**

7. Request for Approval for Final Adoption of Rule 69O-125.003; Unfair Discrimination Because of Travel Plans.

This rule is being amended to remove the requirement that insurers report the refusal or limitation of annuity contracts based on the applicant's past or future travel.

**(ATTACHMENT 7)**

**APPROVAL FOR FINAL ADOPTION**

8. Request for Approval for Final Adoption of Rule 69O-137.002; Annual Audited Financial Reports

The amendments incorporate by reference new editions of standards developed by the American Institute of CPAs that apply to annual audited financial statements.

**(ATTACHMENT 8)**

**APPROVAL FOR FINAL ADOPTION**

**OFFICE OF INSURANCE REGULATION**

GOVERNOR SCOTT: Next I'd like to recognize David Altmaier with the Office of Insurance Regulation.

COMMISSIONER ALTMAIER: Good morning, Governor. Good morning, Cabinet. Thank you for the opportunity to be here this morning.

We've got a couple of items on our agenda. We'll start with the minutes from the March 7th, 2018, meeting. We'd respectfully request your approval of those minutes.

GOVERNOR SCOTT: Is there a motion on the item?

ATTORNEY GENERAL BONDI: So moved.

GOVERNOR SCOTT: Is there a second?

CFO PATRONIS: Second.

GOVERNOR SCOTT: Comments or objections?

(NO RESPONSE).

GOVERNOR SCOTT: Hearing none, the motion carries.

COMMISSIONER ALTMAIER: Thank you.

We can do, if it's appropriate, Governor and Cabinet, the next three agenda items all together. This is a request for publication of rules that are

1 changing things that are either outdated or not  
2 applicable. So we'd respectfully request your  
3 approval for those three items.

4 COMMISSIONER PUTNAM: I've got a question on  
5 one of those.

6 GOVERNOR SCOTT: Okay. Why don't you go ahead  
7 and do your question.

8 COMMISSIONER PUTNAM: I'm not opposed to doing  
9 that. I just want to ask a question on the unfair  
10 discrimination because of travel plans. Will you  
11 walk us through that? Because I remember being  
12 asked about that. What's the controlling law on  
13 that? Is it at state level, federal level, both,  
14 on asking people about their travel plans? Because  
15 I know it has included a number of travel locations  
16 that are important to Floridians.

17 COMMISSIONER ALTMAIER: Yes, sir. And to my  
18 knowledge that is a state law. To my knowledge,  
19 there is not a corresponding federal law.

20 That statute is there so that life insurance  
21 companies cannot discriminate against Floridians  
22 that are planning to travel to some of those  
23 destinations. So if somebody goes to purchase a  
24 life insurance policy and the agent asks if they're  
25 going to a particular location, the life insurance



1        company is not allowed to deny life insurance  
2        coverage for that individual because they are  
3        traveling to that particular location.

4            There are certain locations that are vetted  
5        that are on the list that are accepted. So  
6        war-torn countries, for example, that are deemed to  
7        be unsafe may have an exception to that. But  
8        generally speaking, that is not allowed under  
9        Florida law to not sell somebody life insurance  
10       because of their travel plans.

11           What we're doing with this particular rule is  
12       that because of a drafting glitch when it was  
13       originally published, it included annuities, which  
14       are not covered by the statute because they don't  
15       have the same type of moral risk, so to speak, for  
16       an insurance company to deny coverage for  
17       annuities, because an annuity is essentially a  
18       reverse life insurance policy where you which would  
19       give the insurance company a lump sum and then they  
20       pay premiums back to the insured.

21           So it doesn't have the same level of risk. So  
22       what we're doing here is just striking out  
23       annuities. The same process and requirements for  
24       life insurance companies with respect to freedom of  
25       travel would continue to exist going forward.

1           COMMISSIONER PUTNAM: Well, I'm glad that  
2           you're adding annuities to the protections on life  
3           insurance because for too long Israel was being  
4           discriminated against.

5           COMMISSIONER ALTMAIER: Yes, sir. And if I'm  
6           not mistaken, the crux of not only the statute but  
7           the rule was with respect to travel to Israel.

8           COMMISSIONER PUTNAM: Thank you.

9           COMMISSIONER ALTMAIER: Yes, sir.

10          GOVERNOR SCOTT: All right. Is there a motion  
11          for 2, 3, and 4?

12          COMMISSIONER PUTNAM: I so move.

13          GOVERNOR SCOTT: Is there a second?

14          ATTORNEY GENERAL BONDI: Second.

15          GOVERNOR SCOTT: Any comments or objections?

16          (NO RESPONSE).

17          GOVERNOR SCOTT: Hearing none, the motion  
18          carries.

19          COMMISSIONER ALTMAIER: Thank you very much.

20          That brings us to our last agenda item, which  
21          is, believe it or not, my second annual performance  
22          evaluation. So before I really get into that, I  
23          know you've got a long agenda today, but I just  
24          wanted to say what an honor it has been to stand  
25          along side the people of the Office of Insurance

1 Regulation as they go about their day-to-day  
2 operations of protecting consumers and how humbled  
3 I am on a daily basis that you've entrusted me with  
4 the leadership of the Agency.

5 We've submitted an annual review package which  
6 I would invite you and encourage you to look  
7 through it at your earliest opportunity if you  
8 haven't already. The punch line is that our  
9 performance score this year was a 4.1. This is the  
10 first year under our new performance measures which  
11 were set up to help us identify areas that our  
12 agency could be more efficient and more effective  
13 in what we do.

14 So I'm very pleased with that score, not only  
15 because it's a great score but also because through  
16 that process we have identified processes that we  
17 have that we could make more efficient as we go  
18 about protecting Florida. I'd welcome any  
19 questions that you have on that.

20 I did want to take just a moment to talk about  
21 one of our bigger challenges that we've experienced  
22 not only over the past year but the past two years,  
23 and it dovetails nicely with the conversation that  
24 you just had with Barry Gilway; and that is, the  
25 issue of assignment of benefits.

1           And, Governor, I share in your frustration  
2           that this is an issue that is costing Floridians  
3           money; it's costing Floridians the ability to have  
4           a competitive homeowners insurance market. And  
5           absent hurricanes, it is in my opinion the number 1  
6           threat to the stability of our homeowners insurance  
7           marketplace going forward.

8           So to respond to your question, Governor,  
9           about what the Office of Insurance Regulation has  
10          been doing in order to address this, we're working  
11          very hard on two tracks. And we're working very  
12          closely, CFO Patronis, with you and with your  
13          office and we look forward to continuing that going  
14          forward.

15          The first track is a legislative solution. We  
16          believe that this is not so much an AOB issue as it  
17          is a litigation issue, and we think that the way  
18          that attorneys fees are structured in our state  
19          makes it very enticing for abusive litigation to be  
20          filed against homeowners insurance companies. So  
21          we have worked with the Legislature very hard in an  
22          attempt to close what we view as a loophole on that  
23          front. We have not been successful with that,  
24          unfortunately.

25          So the second work stream that we are actively

1 engaged on is looking for regulatory solutions that  
2 we can implement and the policy forms that will  
3 have a meaningful impact on this issue. And we  
4 have, as Barry Gilway just mentioned, we have  
5 implemented some of those form changes for Citizens  
6 that we think will be effective. We have worked  
7 with other private insurance carriers on other  
8 ideas that have either already been implemented or  
9 that are coming to the table very, very soon in an  
10 effort to address this issue.

11 And we continue to work very hard with  
12 stakeholders to understand what they go through on  
13 a day-to-day basis with this AOB issue. And so we  
14 are hopeful that some of the form changes that  
15 we're implementing will make it much, much harder  
16 for this behavior to continue to go on in our state  
17 so that we can come back to the Legislature next  
18 year with a very comprehensive plan legislatively  
19 that could put this issue to bed going forward.

20 So with that, I'd welcome any questions that  
21 you have on our AOB issue as well as anything with  
22 respect to our annual performance evaluation.

23 GOVERNOR SCOTT: CFO.

24 CFO PATRONIS: Thank you, Governor. And  
25 thank you, Commissioner.

1           As I started to wrap my arms around the AOB  
2       issue and the epidemic that it's created, I don't  
3       even know if I've told the rest of the Cabinet  
4       members, but when we had our Cabinet meeting in  
5       January in Tampa, I'm walking out of the expo  
6       center, and of all people that get approached about  
7       a chipped windshield it was me. There in my suit  
8       with my seven-year-old son and an individual was  
9       fishing for information just to want to scam me  
10      for -- scam my insurance carrier for a windshield  
11      replacement.

12           There wasn't an answer that I could provide to  
13      this individual that did not let him turn me away.  
14      He found this -- and he was very clever and very  
15      thoughtful in the types of questions that he asked.  
16      But this track much of allowing this environment,  
17      some of which I think you're exactly right, needs a  
18      legislative solution. And I know you heard from my  
19      office the need to throw challenges within your  
20      jurisdiction towards this cottage industry that is  
21      growing, you know, exponentially overnight.

22           I looked -- since January to March 18th,  
23      almost 10,000 AOB-related cases just in those three  
24      months. Half of which of those being windshield.  
25      I know our insurance industry, it's about like a

1 lot of industries in the State of Florida. I don't  
2 think all of the different players at the table  
3 will agree on a one-size-fits-all solution to the  
4 AOB dilemma; but, you know, as you've heard from my  
5 office, and I appreciate your office working  
6 towards this, I want to throw as many curves and  
7 wrenches and roadblocks that you have under your  
8 jurisdiction to this.

9 And I know that means extra frustration on  
10 behalf of your offers and it's going to be  
11 headaches for your office to deal with, but I think  
12 doing nothing between now and legislative session  
13 meets is not an option. And it's no different than  
14 what we talked with Barry about trying to turn his  
15 cost of doing business legally back against the  
16 industry and hopefully get the consumers engaged.

17 I don't really think sometimes our  
18 policyholders realize how they're being taken  
19 advantage, because if it's too good to be true, it  
20 is. But I really I am consumed with solutions,  
21 whether it be ridiculous, grand, small. I want --  
22 really, I want your office to throw everything but  
23 the kitchen sink as this and create as many  
24 heartaches and headaches as possible.

25 GOVERNOR SCOTT: So if it's \$150 million for

1 Citizens statewide, just think how big it is.  
2 That's a lot of money that should go back into  
3 Citizens' pocket.

4 CFO PATRONIS: And our citizens of the state  
5 deserve to have legal representation, but I am  
6 not -- I don't have a problem with that. But the  
7 exploitation that's taking place with individuals  
8 coming in and finding a rotten toe kick, giving  
9 them jurisdiction to rip out a kitchen and rip out  
10 a bathroom and then send a \$20,000 bill to a  
11 carrier, you know, there's just a pure fraud that's  
12 existing.

13 And, you know, I don't know -- I don't know  
14 how many different things that you're empowered or  
15 jurisdiction to do; but, you know, even if some of  
16 those solutions might be a stretch, I think it's  
17 worth stretching.

18 COMMISSIONER ALTMAIER: Well, CFO I could not  
19 agree with you more. We also agree that we can't  
20 wait until the next legislative session to work on  
21 solutions. We are entertaining any and all ideas.  
22 In fact, I was at an event yesterday and someone  
23 flagged me down and said: I have your fix for AOB.  
24 Just give me a call.

25 I don't know who he is or what his idea is,



1 but I'm calling him this afternoon. We're taking  
2 all ideas. It could be a bad one that we dismiss;  
3 it could be something that we can work with.

4 So we are listening to every idea. And I want  
5 to assure you that it is not a headache or a  
6 frustration for our office to seek out solutions  
7 that benefit Floridians in the long run. We  
8 welcome that opportunity.

9 We wish we didn't have this problem to deal  
10 with, but since we do, we are all hands on deck in  
11 attempting to find a solution for it.

12 CFO PATRONIS: Well, and the industry has --  
13 as I've made my rounds around the state, the  
14 industry enjoys working with your leadership, they  
15 really do. But, you know, as the industry enjoys  
16 it, what I want to do is that silent customer that  
17 realizes that there's savings there if we change  
18 these unscrupulous activities that are taking place  
19 that are not meant to be part of the cost factor  
20 equation, it really shouldn't.

21 COMMISSIONER ALTMAIER: Absolutely. I look  
22 forward to continue to work with you, CFO, as well  
23 as each of your offices on the Cabinet as we tackle  
24 this issue, any many more.

25 GOVERNOR SCOTT: Any other questions on the

1 report?

2 COMMISSIONER PUTNAM: Keep throwing roadblocks  
3 up.

4 CFO PATRONIS: Exactly.

5 GOVERNOR SCOTT: All right. Is there a motion  
6 to accept?

7 CFO PATRONIS: So move.

8 GOVERNOR SCOTT: Is there a second?

9 COMMISSIONER PUTNAM: Second.

10 GOVERNOR SCOTT: Comments or objections?

11 (NO RESPONSE) .

12 GOVERNOR SCOTT: Hearing none, the motion  
13 carries. Thank you.

14 COMMISSIONER ALTMAIER: Thank you. And again,  
15 I can't stress how appreciative I am for the  
16 opportunity to serve Florida. Thank you and take  
17 care.

18 CFO PATRONIS: Happy anniversary.

19 COMMISSIONER ALTMAIER: Thank you.

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22 \* \* \* \*

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M E M O R A N D U M

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**DATE:** November 15, 2018  
**TO:** David Altmaier, Commissioner, Office of Insurance Regulation  
**THROUGH:** Anoush Brangaccio, General Counsel  
**FROM:** Michael Lawrence, Jr., Assistant General Counsel  
**SUBJECT:** Cabinet Agenda for December 4, 2018  
Request for Approval to Publish Repeal of  
Rule 69O-203.204,.205  
Assignment # 231664-18

The Office of Insurance Regulation requests that these proposed repeal be presented to the Cabinet aides on or before November 28, 2018, and to the Financial Services Commission on December 4, 2018.

The rules govern the Office's review of discount medical plan products. The statutory authority for these rules has been repealed; therefore, the rules are being repealed.

Sections 636.232, 624.424(1)(c); 636.208; 636.216; 636.230, F.S., are the rulemaking authority and laws implemented for these rules.

Michael Lawrence, Jr., is the attorney handling these rules. Attached are: 1) the proposed rule(s), 2) any incorporated materials, such as forms; and 3) copies of the rulemaking statutory authority and law implemented.

Approved for signature:

for   
Anoush Brangaccio, General Counsel

Approved for submission to Financial Services  
Commission:

  
David Altmaier, Commissioner  
Office of Insurance Regulation

**69O-203.204 Filing, Approval of DPO ~~DMPO~~ Plans, Rates and Related Forms.**

*Rulemaking Authority 636.232 FS. Law Implemented 624.424(1)(c), 636.208, 636.216 FS. History—New 4-7-05, Amended 5-4-06, 11-1-07, Repealed.*

**69O-203.205 Bundled Products.**

*Rulemaking ~~Specific~~ Authority 636.232 FS. Law Implemented 636.230 FS. History—New 5-4-06, Amended 11-1-07, Repealed.*

**690-203.204 Filing, Approval of DPO ~~DMPO~~ Plans, Rates and Related Forms.**

(1) The DMPO shall file all charges with the Office and shall file for approval by the Office each of the following before use:

(a) All Plan contracts, to be used or issued in connection with any Plan; and

(b)1. Any periodic charge for any Plan that is in excess of \$50.00 per month, if the plan includes at least the following services: physician services licensed under Chapter 458 or 459, F.S., dental services, vision services, chiropractic services, and podiatric services, but does not include hospital services.

2. Any periodic charge for any other Plan, whether the Plan includes one or more services, that is in excess of \$30.00 per month.

(2) Free Plans. The Plan contracts and charges of a Plan that is purchased from a DMPO and subsequently provided at no charge to individuals by an insurer, bank, credit union, or employer are exempt from paragraph 690-203.202(1)(e) and (f), F.A.C.

(3) All filings shall be submitted to the Office electronically to <http://www.flor.com/portal>.

(4) A filing shall consist of the following items:

(a) A letter explaining the type and nature of the filing. The letter shall indicate if the filing is for a new Plan, rate revision or a resubmission. If the filing is a resubmission, the letter shall indicate when the previous filing was submitted, the Florida filing number, the date of the disapproval or withdrawal and previous correspondence between the DMPO and the Office.

(b) Form OIR-1507, "Office of Insurance Regulation, Life and Health Forms and Rates Universal Standardized Data Letter," completely filled out in accordance with Form OIR-1507A, "Office of Insurance Regulation, Life and Health Forms and Rates Universal Standardized Data Letter Instruction Sheet" as adopted by Rule 690-149.022, F.A.C.

(c) The material being submitted, which may include one or more of the following:

1. ~~Charges; or~~

2. ~~Contracts, applications or other forms.~~

~~(d) Discount Medical Plan Organization Review Standards Checklist, Form OIR B2-1607, as adopted by Rule 69O-149.022, F.A.C.~~

~~(e) Other information as indicated in Rule 69O-203.205, F.A.C., as applicable.~~

*Rulemaking Authority 636.232 FS. Law Implemented 624.424(1)(c), 636.208, 636.216 FS. History—New 4-7-05, Amended 5-4-06, 11-1-07, Amended \_\_\_\_\_.*

**69O-203.205 Bundled Products.**

~~(1) The provisions of Section 636.230, F.S., recognize that the discount medical plan may be combined together with other products. When a bundled product is sold, the DPO DMPO must provide the charges attributable to the discount medical plan component in writing to the member if the total monthly charges for the bundled product exceed the limits of \$30.00 or \$50.00 as provided in paragraph 69O-203.204(1)(b), F.A.C. Any filing of a bundled product made pursuant to Rule 69O-203.204, F.A.C., shall clearly identify the discount medical plan component separately from each other component.~~

~~(2) When the bundled product contains a product that is insurance or other regulated product, the filing shall contain the following:~~

~~(a) Identification of the licensed insurer underwriting the insurance product,~~

~~(b) Disclosure of the specific policy form number providing the underlying insurance coverage issued by the licensed insurer,~~

~~(c) Disclosure of the Florida filing log number where the insurance product was filed with the Office,~~

~~(d) A copy of the rate schedule from the insurer on insurer paper or letterhead identifying the product and rates for the coverage being bundled with the discount plan,~~

~~(e) Identification of how the discount plan applicant is applying for the insurance coverage, i.e., on the enrollment~~

form, complete a separate application, etc., and

~~(f) When the insurance coverage is provided under a group policy:~~

~~1. Identification of the group policyholder that the insurance coverage is issued to, and~~

~~2. An explanation of how the discount plan applicant is an eligible individual for coverage under the group pursuant to the group's eligibility standards.~~

~~(3) When the bundled product contains insurance or other products subject to regulation and approval by the Office, a DMPO may submit for approval a combined application. Each product that is involved in the sale of the bundled product, combined application, and the charges relating to each component of the bundled product must be filed in accordance with the laws and regulations applicable to each component.~~

*Rulemaking Specific Authority 636.232 FS. Law Implemented 636.230 FS. History—New 5-4-06, Amended 11-1-07,*

*Amended \_\_\_\_\_*

636.232 Rules.—The commission may adopt rules to administer this part, including rules for the licensing of discount plan organizations, providing for the collection of data, relating to disclosures to plan members, and defining terms used in this part.

636.208 Fees; charges; reimbursement.—

(1) A discount plan organization may charge a periodic charge as well as a reasonable one-time processing fee for a discount plan.

(2)(a) If the member cancels his or her membership in the discount plan organization within the first 30 days after the effective date of enrollment in the plan, the member shall receive a reimbursement of all periodic charges upon return of the discount card to the discount plan organization.

(b) If the member cancels his or her membership in the discount plan organization after the first 30 days, the discount plan organization:

1. Must cancel the membership on or before 30 days after receipt of the member's cancellation request.

2. May not charge the member any fees after the effective date of the cancellation of the membership.

3. Must provide a pro rata reimbursement of periodic charges made for months after the cancellation date.

(c) If the member cancels his or her membership in the discount plan organization consistent with the open enrollment rules established by an employer or association for a plan having an open enrollment period, the member shall receive a pro rata reimbursement of all periodic charges upon return of the discount card to the discount plan organization.

(3) If the discount plan organization cancels a membership for any reason other than nonpayment of fees by the member, the discount plan organization must make a pro rata reimbursement of all periodic charges to the member.

(4) In addition to the reimbursement of periodic charges for the reasons stated in subsections (2) and (3), a discount plan organization shall also reimburse the member for any portion of a one-time processing fee that exceeds \$30 per year.

636.216 Written agreement.—There must be a written agreement between the discount plan organization and the member specifying the benefits under the discount plan and complying with the disclosure requirements of this part.

636.230 Bundling discount plans with other products.—A marketer or discount plan organization selling a discount plan with medical services and other services may commingle those products on a single page of forms, advertisements, marketing materials, or brochures.

624.424 Annual statement and other information.—

(1) (c) The commission may by rule require reports or filings required under the insurance code to be submitted by electronic means in a computer-readable form compatible with the electronic data processing equipment specified by the commission.



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**M E M O R A N D U M**

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**DATE:** November 15, 2018  
**TO:** David Altmaier, Commissioner, Office of Insurance Regulation  
**THROUGH:** Anoush Brangaccio, General Counsel  
**FROM:** Michael Lawrence, Jr., Assistant General Counsel  
**SUBJECT:** Cabinet Agenda for December 4, 2018  
Request for Approval to Publish Amendments to  
Rule 69O-203.201,.202,.203,.210  
Assignment # 231661-18

The Office of Insurance Regulation requests that these proposed rule amendments be presented to the Cabinet aides on or before November 28, 2018, and to the Financial Services Commission on December 4, 2018.

These rules are being amended to conform to the changes made to Chapter 636, Part II, Discount Plan Organizations, Sections 636.202 – 636.244, Florida Statutes, by Chapter 2017-112, Laws of Florida, and to update forms.

Sections 624.424(1)(c), 636.232, 624.424, 636.202, 636.204, 636.216, 636.218, 636.220, 636.226, 636.228, 636.234, 636.236, F.S., are the rulemaking authority and laws implemented for these rules.

Michael Lawrence, Jr., is the attorney handling these rules. Attached are: 1) the proposed rule(s), 2) any incorporated materials, such as forms; and 3) copies of the rulemaking statutory authority and law implemented.

Approved for signature:

  
Anoush Brangaccio, General Counsel

Approved for submission to Financial Services  
Commission:

  
David Altmaier, Commissioner  
Office of Insurance Regulation

69O-203.201 Definitions.

(1) No change.

(2) Contract or Form means the document, by whatever name called; such as agreement, certificate or handbook which describes the benefits under the Ddiscount medical Plan.

(3) Discount Medical Plan (Plan) means a business arrangement or contract in which a person, in exchange for fees, dues, charges, or other consideration, provides access for Pplan members to providers of medical services and the right to receive one or more medical services from those providers at a discount.

(4) DPO DMPO is the Discount Medical Plan Organization defined in Section 636.202(2), F.S., that contracts with providers, provider networks, or other DPOs, DMPOs, to provide discounted medical services to Plan members and determines the charges to the members.

(5) No change.

*Rulemaking Specific Authority 636.232 FS. Law Implemented 636.202 FS. History--New 4-7-05, Amended*

69O-203.202 Standards for Discount Medical Plans.

(1) No change.

(a) Name and address of the DPO DMPO;

(b) through (l) No change.

(j) Provisions for adding new family members; and

~~(k) All plan contracts and application forms shall have a unique form number in the lower left hand corner; and~~

~~(k)(4) Member complaint procedure.~~

(2) No change.

~~(3) (a) All charges to members must be filed with the Office, and the Office must approve any periodic charge exceeding \$30.00 per month, or \$50.00 per month as provided by paragraph 69O 203.204(1)(b), F.A.C., for the contract issued and not per member covered on the contract, before the periodic charges can be used. Periodic charges approved pursuant to this paragraph must remain in compliance with this paragraph. Consequently, subsequent to the initial approval, the periodic charges remain subject to review by the Office to ensure continued compliance.~~

~~(b) In a filing made pursuant to paragraph (a) above, the discount medical plan organization has the burden of proof that the periodic charges bear a reasonable relationship to the benefits received by the member. If the discount medical plan organization uses member savings as the basis of demonstrating the benefits received by the member, the benefits shall be benefits and savings that can be reasonably anticipated by an average Floridian who may purchase such contract.~~

~~(c) A discount medical plan organization may, at its option, make a filing that meets one of the following standards that have been determined to meet the requirement of paragraph (b) above:~~

~~1. The discount medical plan organization provides financial information to demonstrate that at least sixty percent (60%) of the periodic charge is used to pay the costs associated with providing access to discount medical services, excluding any administrative costs, commissions and profits; or~~

~~2. The discount medical plan organization provides financial information to demonstrate that the plan's periodic charge does not exceed sixty percent (60%) of the actual benefit of the discounted services to members, measured as the actual savings realized by members, i.e., provider billed charges without the discount less the discounted provider charges paid by the member. These values shall be measured in the aggregate for all members and all actual services utilized over a period of twelve months with experience from at least 2,000 members; or~~

~~3. The discount medical plan organization provides specific financial information to demonstrate that at least seventy five percent (75%) of the periodic charge is used to pay the costs associated with providing access to discount medical services, member support services and administrative costs excluding commissions and profits.~~

*Rulemaking Specific Authority 636.232 FS. Law Implemented 636.216 FS. History--New 4-7-05, Amended 11-1-07,*

69O-203.203 Standards for the Form and Content of Advertisements or Marketing Materials.

(1) No change.

(2) (a) through (c) No change.

(d) The term “insurance” may not be used as a descriptive term for DPO ~~DMPD~~ benefits. However, the term “insurance” may be used in a disclaimer of any relationship between DPO ~~DMPD~~ benefits and insurance including the disclosures required in Section 636.212, F.S.

Rulemaking Specific Authority 636.232 FS. Law Implemented 636.228 FS. History—New 4-7-05, Amended

Substantial rewording of Rule 69O-203.210, F.A.C. follows. See Florida Administrative Code for present text.

69O-203.210 Forms Incorporated by Reference.

(1) The following forms are hereby incorporated by reference:

(a) Form OIR-C1-1606, Application for License Discount Plan Organization (DPO), effective 01/18, available at [www.flrules.org/XXXXX](http://www.flrules.org/XXXXX);

(b) Form OIR-C1-1423, Biographical Affidavit, effective 03/18, available at [www.flrules.org/XXXXX](http://www.flrules.org/XXXXX);

(c) Form OIR-C1-938, Fingerprint Payment and Submission Procedure, effective 10/18, available at [www.flrules.org/XXXXX](http://www.flrules.org/XXXXX);

(d) Form OIR-C1-144, Service of Process Consent & Agreement, effective 06/04, available at [www.flrules.org/XXXXX](http://www.flrules.org/XXXXX);

(e) Form OIR-C1-1298, Management Information Form Complete List of Officers, Directors, and Shareholders (10% or more), effective 03/18, available at [www.flrules.org/XXXXX](http://www.flrules.org/XXXXX); and

(f) OIR-A1-1671, Annual Report – Discount Plan Organizations (05/18), available at [www.flrules.org/XXXXX](http://www.flrules.org/XXXXX);

(g) Form OIR-C1-905, Instructions for Furnishing Background Investigative Reports, effective 02/15, available at [www.flrules.org/XXXXX](http://www.flrules.org/XXXXX).

(2) All of the above referenced forms are available and may be printed from the Office of Insurance Regulation’s website: <http://www.flor.com/iportal>.

Rulemaking Authority 624.424(1)(c), 636.232 FS. Law Implemented 624.424, 636.204, 636.218, 636.220, 636.226, 636.228, 636.234, 636.236 FS. History—New 5-22-05, Amended 10-29-08, 7-30-17, Amended

624.424 Annual statement and other information.—

(1)(a) Each authorized insurer shall file with the office full and true statements of its financial condition, transactions, and affairs. An annual statement covering the preceding calendar year shall be filed on or before March 1, and quarterly statements covering the periods ending on March 31, June 30, and September 30 shall be filed within 45 days after each such date. The office may, for good cause, grant an extension of time for filing an annual or quarterly statement. The statements must contain information generally included in insurers' financial statements prepared in accordance with generally accepted insurance accounting principles and practices and in a form generally used by insurers for financial statements, sworn to by at least two executive officers of the insurer or, if a reciprocal insurer, by oath of the attorney in fact or its like officer if a corporation. To facilitate uniformity in financial statements and to facilitate office analysis, the commission may by rule adopt the form and instructions for financial statements approved by the NAIC in 2014, and subsequent amendments thereto if the methodology remains substantially consistent, and may by rule require each insurer to submit to the office, or such organization as the office may designate, all or part of the information contained in the financial statement in a computer-readable form compatible with the electronic data processing system specified by the office.

(b) Each insurer's annual statement must contain:

1. A statement of opinion on loss and loss adjustment expense reserves made by a member of the American Academy of Actuaries or by a qualified loss reserve specialist, pursuant to criteria established by rule of the commission. In adopting the rule, the commission shall consider any criteria established by the NAIC. The office may require semiannual updates of the annual statement of opinion for a particular insurer if the office has reasonable cause to believe that such reserves are understated to the extent of materially misstating the financial position of the insurer. Workpapers in support of the statement of opinion must be provided to the office upon request. This paragraph does not apply to life insurance, health insurance, or title insurance.
2. An actuarial opinion summary written by the insurer's appointed actuary. The summary must be filed in accordance with the appropriate NAIC property and casualty annual statement instructions. Proprietary business information contained in the summary is confidential and exempt under s. 624.4212, and the summary and related information are not subject to subpoena or discovery directly from the office. Neither the office nor any person who received documents, materials, or other information while acting under the authority of the office, or with whom such information is shared pursuant to s. 624.4212, may testify in a private civil action concerning such confidential information. However, the department or office may use the confidential and exempt information in the furtherance of any regulatory or legal action brought against an insurer as a part of the official duties of the department or office. No waiver of any other applicable claim of confidentiality or privilege may occur as a result of a disclosure to the office under this section or any other section of the insurance code. This paragraph does not apply to life and health insurers subject to s. 625.121(3) before the operative date of the valuation manual as defined in s. 625.1212(2), and does not apply to life and health insurers subject to s. 625.1212(4) on or after such operative date.

(c) The commission may by rule require reports or filings required under the insurance code to be submitted by electronic means in a computer-readable form compatible with the electronic data processing equipment specified by the commission.

(2) The statement of an alien insurer shall be verified by the insurer's United States manager or other officer duly authorized. It shall be a separate statement, to be known as its general statement, of its transactions, assets, and affairs within the United States unless the office requires otherwise. If the office requires a statement as to the insurer's affairs elsewhere, the insurer shall file such statement with the office as soon as reasonably possible.

(3) Each insurer having a deposit as required under s. 624.411 shall file with the office annually with its annual statement a certificate to the effect that the assets so deposited have a market value equal to or in excess of the amount of deposit so required.

(4) At the time of filing, the insurer shall pay the fee for filing its annual statement in the amount specified in s. 624.501.

(5) The office may refuse to continue, or may suspend or revoke, the certificate of authority of an insurer failing to file its annual or quarterly statements and accompanying certificates when due.

(6) In addition to information called for and furnished in connection with its annual or quarterly statements, an insurer shall furnish to the office as soon as reasonably possible such information as to its transactions or affairs as the office may from time to time request in writing. All such information furnished pursuant to the office's request shall be verified by the oath of two executive officers of the insurer or, if a reciprocal insurer, by the oath of the attorney in fact or its like officers if a corporation.

(7) The signatures of all such persons when written on annual or quarterly statements or other reports required by this section shall be presumed to have been so written by authority of the person whose signature is affixed thereon. The affixing of any signature by anyone other than the purported signer constitutes a felony of the second degree, punishable as provided in s. 775.082, s. 775.083, or s. 775.084.

(8)(a) All authorized insurers must have conducted an annual audit by an independent certified public accountant and must file an audited financial report with the office on or before June 1 for the preceding year ending December 31. The office may require an insurer to file an audited financial report earlier than June 1 upon 90 days' advance notice to the insurer. The office may immediately suspend an insurer's certificate of authority by order if an insurer's failure to file required reports, financial statements, or information required by this subsection or rule adopted pursuant thereto creates a significant uncertainty as to the insurer's continuing eligibility for a certificate of authority.

(b) Any authorized insurer otherwise subject to this section having direct premiums written in this state of less than \$1 million in any calendar year and fewer than 1,000 policyholders or certificateholders of directly written policies nationwide at the end of such calendar year is exempt from this section for such year unless the office makes a specific finding that compliance is necessary in order for the office to carry out its statutory responsibilities. However, any insurer having assumed premiums pursuant to contracts or treaties or reinsurance of \$1 million or more is not exempt. Any insurer subject to an exemption must submit by March 1 following the year to which the exemption applies an affidavit sworn to by a responsible officer of the insurer specifying the amount of direct premiums written in this state and number of policyholders or certificateholders.

(c) The board of directors of an insurer shall hire the certified public accountant that prepares the audit required by this subsection and the board shall establish an audit committee of three or more directors of the insurer or an affiliated company. The audit committee shall be responsible for discussing audit findings and interacting with the certified public accountant with regard to her or his findings. The audit committee shall be comprised of members who are free from any relationship that, in the opinion of its board of directors, would interfere with the exercise of independent judgment as a committee member. The audit committee shall report to the board any findings of adverse financial conditions or significant deficiencies in internal controls that have been noted by the accountant. The insurer may request the office to waive this requirement of the audit committee membership based upon unusual hardship to the insurer.

(d) An insurer may not use the same accountant or partner of an accounting firm responsible for preparing the report required by this subsection for more than 5 consecutive years. Following this period, the insurer may not use such accountant or partner for a period of 5 years, but may use another accountant or partner of the same firm. An insurer may request the office to waive this prohibition based upon an unusual hardship to the insurer

and a determination that the accountant is exercising independent judgment that is not unduly influenced by the insurer considering such factors as the number of partners, expertise of the partners or the number of insurance clients of the accounting firm; the premium volume of the insurer; and the number of jurisdictions in which the insurer transacts business.

(e) The commission shall adopt rules to administer this subsection which must be in substantial conformity with the 2006 Annual Financial Reporting Model Regulation adopted by the NAIC or subsequent amendments, except where inconsistent with the requirements of this subsection. Any exception to, waiver of, or interpretation of accounting requirements of the commission must be in writing and signed by an authorized representative of the office. An insurer may not raise an exception to, waiver of, or interpretation of accounting requirements as a defense in an action, unless previously issued in writing by an authorized representative of the office.

(9)(a) Each authorized insurer shall, pursuant to s. 409.910(20), provide records and information to the Agency for Health Care Administration to identify potential insurance coverage for claims filed with that agency and its fiscal agents for payment of medical services under the Medicaid program.

(b) Each authorized insurer shall, pursuant to s. 409.2561(5)(c), notify the Medicaid agency of a cancellation or discontinuance of a policy within 30 days if the insurer received notification from the Medicaid agency to do so.

(c) Any information provided by an insurer under this subsection does not violate any right of confidentiality or contract that the insurer may have with covered persons. The insurer is immune from any liability that it may otherwise incur through its release of such information to the Agency for Health Care Administration.

(10) Each insurer or insurer group doing business in this state shall file on a quarterly basis in conjunction with financial reports required by paragraph (1)(a) a supplemental report on an individual and group basis on a form prescribed by the commission with information on personal lines and commercial lines residential property insurance policies in this state. The supplemental report shall include separate information for personal lines property policies and for commercial lines property policies and totals for each item specified, including premiums written for each of the property lines of business as described in ss. 215.555(2)(c) and 627.351(6)(a). The report shall include the following information for each county on a monthly basis:

- (a) Total number of policies in force at the end of each month.
- (b) Total number of policies canceled.
- (c) Total number of policies nonrenewed.
- (d) Number of policies canceled due to hurricane risk.
- (e) Number of policies nonrenewed due to hurricane risk.
- (f) Number of new policies written.
- (g) Total dollar value of structure exposure under policies that include wind coverage.
- (h) Number of policies that exclude wind coverage.

(11) Each insurer doing business in this state which reinsures through a captive insurance company as defined in s. 628.901, but without regard to domiciliary status, shall, in conjunction with the annual financial statement required under paragraph (1)(a), file a report with the office containing financial information specific to reinsurance assumed by each captive.

(a) The report shall be filed as a separate schedule designed to avoid duplication of disclosures required by the NAIC's annual statement and instructions.

(b) Insurers must:

1. Identify the products ceded to the captive and whether the products are subject to rule 690-164.020, Florida Administrative Code, the NAIC Valuation of Life Insurance Policies Regulation (Model #830), or the NAIC Actuarial Guideline XXXVIII (AG 38).

2. Disclose the assets of the captive in the format prescribed in the NAIC annual statement schedules.
3. Include a stand-alone actuarial opinion or certification identifying the differences between the assets the ceding company would be required to hold and the assets held by the captive.

and if the office is satisfied that the organization is in compliance with this act.

636.202 Definitions.—As used in this part, the term:

- (1) "Discount plan" means a business arrangement or contract in which a person, in exchange for fees, dues, charges, or other consideration, provides access for plan members to providers of medical services and the right to receive medical services from those providers at a discount. The term does not include any product regulated under chapter 627, chapter 641, or part I of this chapter; any medical services provided through a telecommunications medium that does not offer a discount to the plan member for those medical services; or any plan that does not charge a fee to plan members. Until June 30, 2018, a discount plan may also be referred to as a discount medical plan.
- (2) "Discount plan organization" means an entity that, in exchange for fees, dues, charges, or other consideration, provides access for plan members to providers of medical services and the right to receive medical services from those providers at a discount. Until June 30, 2018, a discount plan organization may also be referred to as a discount medical plan organization.
- (3) "Marketer" means a person or entity that markets, promotes, sells, or distributes a discount plan, including a private label entity that places its name on and markets or distributes a discount plan but does not operate a discount plan.
- (4) "Medical services" means any care, service, or treatment of illness or dysfunction of, or injury to, the human body, including, but not limited to, physician care, inpatient care, hospital surgical services, emergency services, ambulance services, dental care services, vision care services, mental health services, substance abuse services, chiropractic services, podiatric care services, laboratory services, and medical equipment and supplies. The term does not include pharmaceutical supplies or prescriptions.
- (5) "Member" means any person who pays fees, dues, charges, or other consideration for the right to receive the purported benefits of a discount plan.
- (6) "Provider" means any person or institution that is contracted, directly or indirectly, with a discount plan organization to provide medical services to members.
- (7) "Provider network" means an entity that negotiates on behalf of more than one provider with a discount plan organization to provide medical services to members.

636.204 License required.—

- (1) Before doing business in this state as a discount plan organization, an entity must be a corporation, a limited liability company, or a limited partnership, incorporated, organized, formed, or registered under the laws of this state or authorized to transact business in this state in accordance with chapter 605, part I of chapter 607, chapter 617, chapter 620, or chapter 865, and must be licensed by the office as a discount plan organization or be licensed by the office pursuant to chapter 624, part I of this chapter, or chapter 641.
- (2) An application for a license to operate as a discount plan organization must be filed with the office on a form prescribed by the commission. Such application must be sworn to by an officer or authorized representative of the applicant and be accompanied by the following, if applicable:
  - (a) A copy of the applicant's articles of incorporation or other organizing documents, including all amendments.
  - (b) A copy of the applicant's bylaws.

(c) A list of the names, addresses, official positions, and biographical information of the individuals who are responsible for conducting the applicant's affairs, including, but not limited to, all members of the board of directors, board of trustees, executive committee, or other governing board or committee, the officers, contracted management company personnel, and any person or entity owning or having the right to acquire 10 percent or more of the voting securities of the applicant. Such listing must fully disclose the extent and nature of any contracts or arrangements between any individual who is responsible for conducting the applicant's affairs and the discount plan organization, including any possible conflicts of interest.

(d) A complete biographical statement on forms prescribed by the commission, an independent investigation report, and a set of fingerprints, as provided in chapter 624, with respect to each individual identified under paragraph (c).

(e) A statement generally describing the applicant, its facilities and personnel, and the medical services to be offered.

(f) A copy of the form of all contracts made or to be made between the applicant and any providers or provider networks regarding the provision of medical services to members.

(g) A copy of the form of any contract made or arrangement to be made between the applicant and any person listed in paragraph (c).

(h) A copy of the form of any contract made or to be made between the applicant and any person, corporation, partnership, or other entity for the performance on the applicant's behalf of any function, including, but not limited to, marketing, administration, enrollment, investment management, and subcontracting for the provision of health services to members.

(i) A copy of the applicant's most recent financial statements audited by an independent certified public accountant. An applicant that is a subsidiary of a parent entity that is publicly traded and that prepares audited financial statements reflecting the consolidated operations of the parent entity and the subsidiary may petition the office to accept, in lieu of the audited financial statement of the applicant, the audited financial statement of the parent entity and a written guaranty by the parent entity that the minimum capital requirements of the applicant required by this part will be met by the parent entity.

(j) A description of the proposed method of marketing.

(k) A description of the subscriber complaint procedures to be established and maintained.

(l) The fee for issuance of a license.

(m) Such other information as the commission or office may reasonably require to make the determinations required by this part.

(3) The office shall issue a license which shall expire 1 year later, and each year on that date thereafter, and which the office shall renew if the licensee pays the annual license fee of \$50 and if the office is satisfied that the licensee is in compliance with this part.

(4) Before licensure by the office, each discount plan organization must establish an Internet website so as to conform to the requirements of s. 636.226.

(5) The license fee under subsection (2) is \$50 per year per licensee. All amounts collected shall be deposited into the General Revenue Fund.

(6) This part does not require a provider who provides discounts to his or her own patients to obtain and maintain a license as a discount plan organization.

#### 636.216 Charge or form filings.—

(1) All charges to members must be filed with the office and any charge to members greater than \$30 per month or \$360 per year must be approved by the office before the charges can be used. The discount medical plan organization has the burden of proof that the charges bear a reasonable relation to the benefits received by the member.

(2) There must be a written agreement between the discount medical plan organization and the member specifying the benefits under the discount medical plan and complying with the disclosure requirements of this part.



(3) All forms used, including the written agreement pursuant to subsection (2), must first be filed with and approved by the office. Every form filed shall be identified by a unique form number placed in the lower left corner of each form.

(4) A charge or form is considered approved on the 60th day after its date of filing unless it has been previously disapproved by the office. The office shall disapprove any form that does not meet the requirements of this part or that is unreasonable, discriminatory, misleading, or unfair. If such filings are disapproved, the office shall notify the discount medical plan organization and shall specify in the notice the reasons for disapproval.

636.218 Annual reports.—

(1) Each discount plan organization shall file with the office, within 3 months after the end of each fiscal year, an annual report.

(2) Such reports must be on forms prescribed by the commission and must include:

(a) Audited financial statements prepared in accordance with generally accepted accounting principles certified by an independent certified public accountant, including the organization's balance sheet, income statement, and statement of changes in cash flow for the preceding year. An organization that is a subsidiary of a parent entity that is publicly traded and that prepares audited financial statements reflecting the consolidated operations of the parent entity and the organization may petition the office to accept, in lieu of the audited financial statement of the organization, the audited financial statement of the parent entity and a written guaranty by the parent entity that the minimum capital requirements of the organization required by this part will be met by the parent entity.

(b) If different from the initial application or the last annual report, a list of the names and residence addresses of all persons responsible for the conduct of the organization's affairs, together with a disclosure of the extent and nature of any contracts or arrangements between such persons and the discount plan organization, including any possible conflicts of interest.

(c) The number of discount plan members in the state.

(d) Such other information relating to the performance of the discount plan organization as is reasonably required by the commission or office.

(3) Every discount plan organization that fails to file an annual report in the form and within the time required by this section shall forfeit up to \$500 for each day for the first 10 days during which the neglect continues and shall forfeit up to \$1,000 for each day after the first 10 days during which the neglect continues; and, upon notice by the office to that effect, the organization's authority to enroll new members or to do business in this state ceases while such default continues. The office shall deposit all sums collected by the office under this section to the credit of the Insurance Regulatory Trust Fund. The office may not collect more than \$50,000 for each report.

636.220 Minimum capital requirements.—

(1) Each discount plan organization shall at all times maintain a net worth of at least \$150,000.

(2) The office may not issue a license unless the discount plan organization has a net worth of at least \$150,000.

636.226 Provider name listing.—Each discount plan organization must maintain on an Internet website an up-to-date list of the names and addresses of the providers with which it has contracted, the address of which must be prominently displayed on all its advertisements, marketing materials, brochures, and discount cards. This section applies to those providers with whom the discount plan organization has contracted directly, as well as

those who are members of a provider network with which the discount plan organization has contracted.

636.228 Marketing of discount plans.—

- (1) All advertisements, marketing materials, brochures, and discount cards used by marketers must be approved in writing by the discount plan organization.
- (2) The discount plan organization must have an executed written agreement with a marketer before the marketer's marketing, promoting, selling, or distributing the discount plan. Such agreement must prohibit the marketer from using marketing materials, brochures, and discount cards without the approval in writing by the discount plan organization. The discount plan organization may delegate functions to its marketers but shall be bound by any acts of its marketers, within the scope of the delegation, which do not comply with this part.

636.232 Rules.—The commission may adopt rules to administer this part, including rules for the licensing of discount plan organizations, providing for the collection of data, relating to disclosures to plan members, and defining terms used in this part.

636.234 Service of process on a discount plan organization.—Sections 624.422 and 624.423 apply to a discount plan organization as if the discount plan organization were an insurer.

636.236 Surety bond or security deposit.—

- (1) Each discount plan organization licensed pursuant to this part shall maintain in force a surety bond in its own name in an amount not less than \$35,000 to be used at the discretion of the office to protect the financial interests of members who may be adversely affected by the insolvency of a discount plan organization. The bond must be issued by an insurance company that is licensed to do business in this state.
- (2) In lieu of the bond specified in subsection (1), a licensed discount plan organization may deposit and maintain deposited in trust with the department securities eligible for deposit under s. 625.52 having at all times a value of not less than \$35,000. If a licensed discount plan organization substitutes its deposited securities under this subsection with a surety bond authorized in subsection (1), such deposited securities must be returned to the discount plan organization no later than 45 days following the effective date of the surety bond.
- (3) A judgment creditor or other claimant of a discount plan organization, other than the office or department, does not have the right to levy upon any of the assets or securities held in this state as a deposit under subsections (1) and (2).



**Office of Insurance Regulation**  
**Company Admissions**

**FINGERPRINT PAYMENT AND SUBMISSION PROCEDURE**

Individuals subject to the fingerprinting process must be registered through IdentoGO by Idemia, formerly MorphoTrust USA, at <https://fl.ibtfingerprint.com/>. Individuals may contact the Customer Service Center at 1-800-528-1358 regarding payment, processing or appointment issues.

**LiveScan (available to Florida Residents):**

Access <https://fl.ibtfingerprint.com/>, select "Schedule a New Appointment" and continue. Retain copy of payment confirmation. Payment confirmations will be a required component in the electronic application submitted via iApply.

**Paper Card (available to Non-Residents or Florida residents who affirm they are physically unable to be digitally fingerprinted):**

Access <https://fl.ibtfingerprint.com/>, select "Register for Fingerprint Card Processing Service" and continue. Select "No Cards" on the Shipping Details screen. Retain copy of payment confirmation. Payment confirmations will be a required component in the electronic application submitted via iApply.

Individuals must complete **two** fingerprint cards provided by the Office of Insurance Regulation. Blank fingerprint cards may be requested by emailing [FPRequest@floir.com](mailto:FPRequest@floir.com).

Fingerprints must be taken by a technician within a law enforcement agency or other authorized entity. Most law enforcement agencies and many security companies provide civil applicant fingerprinting services.

**Payment Confirmation Number: Please print your Payment Confirmation Number from the IdentoGo website on the "REF" line of the fingerprint card. Not including your Payment Confirmation Number will result in a delay of processing your submission.**

Mail **ONLY** completed cards with a cover letter to:

Florida Office of Insurance Regulation  
Market Research & Technology Unit  
Fingerprint Card Processing  
200 East Gaines Street, Room B-15  
Tallahassee, Florida 32399-0326

**Do NOT mail application paperwork with your fingerprint cards. All application materials must be sent directly to the appropriate unit (Property & Casualty Company Admissions or Life & Health Company Admissions) within the Office of Insurance Regulation. Failure to do so will result in a delay to your application.**

## **CONFIDENTIAL**

Pursuant to section 119.071(5), Florida Statutes, social security numbers collected by an agency are confidential and exempt from section 119.07(1), Florida Statutes, and section 24(a), Art. I of the State Constitution. The requirement must be relevant to the purpose for which collected and must be clearly documented. The social security numbers must be segregated on a separate page from the rest of the record.

Applicant's Name: \_\_\_\_\_

Applicant's Social Security Number: \_\_\_\_\_

The requirement for the applicant's social security is mandatory.

Section 119.071(5), Florida Statutes, gives authority for an agency to collect social security numbers if imperative for the performance of that agency's duties and responsibilities as prescribed by law. Limited collection of social security numbers is imperative for the Office of Insurance Regulation. The duties of the Office of Insurance Regulation in background investigation are extensive in order to ensure that the owners, management, officers, and directors of any insurer are competent and trustworthy, possess financial standing and business experience, and have not been found guilty of, or not pleaded guilty or nolo contendere to, any felony or crime punishable by imprisonment of one year. In establishing these qualifications and the Office of Insurance Regulation's responsibility to ensure that individuals meet these qualifications, the legislature recognized that owners, officers, and directors of an insurance company are in a position to cause great harm to the public should they be untrustworthy or have a criminal background. These individuals control vast amount of funds that belong to policyholders. To meet the legislative intent that these people are qualified to be trusted, having the identifying social security number is essential for the Office of Insurance Regulation to adequately perform the background investigative duty. There are many individuals with the same name, without this identifying number it would be difficult if not impossible to be reasonably sure that the correct individuals are identified and verify they meet the statutorily required conditions.

## **CONFIDENTIAL**

**UNIFORM CERTIFICATE OF AUTHORITY APPLICATION (UCAA)**  
**Management Information Form**  
**Complete Listing of Incorporators\*, Officers**  
**Directors and Shareholders (10% or more)**

Incorporators\*

Titles:

Ownership Percentage:

Officers:

Directors:

Shareholders:

\* Primary Application Only



**Office of Insurance Regulation**  
**Company Admissions**

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**INSTRUCTIONS FOR FURNISHING BACKGROUND INVESTIGATIVE REPORTS**

1. A background investigative report must be completed for each individual as indicated in the instructions in the application package.
2. Please refer to the NAIC website at [http://www.naic.org/industry\\_ucaa.htm](http://www.naic.org/industry_ucaa.htm), "Third Party Vendors for Background Reports", for specific information regarding background investigation vendors.
3. The applicant is responsible for paying for the reports and for handling billing arrangements with the selected vendor.
4. Applicants are required to ensure that the selected vendor will transmit investigative reports electronically to the Florida Office of Insurance Regulation ("Office") to this e-mail address: [bkgrnd-inv@flor.com](mailto:bkgrnd-inv@flor.com) in Microsoft Word format, with appropriate reference to the applicant in the subject of each transmittal e-mail. Reports should be submitted prior to or contemporaneously with the submission of each application filing, with the exception of acquisition filings.
6. Applicants must include evidence indicating that background reports have been ordered, including proof of payment, as a component in the online submission via iApply.
7. Any questions regarding this process may be directed to the Office at [appcoord@flor.com](mailto:appcoord@flor.com)

# SERVICE OF PROCESS CONSENT & AGREEMENT

(Please type or print all information clearly)

☐ Original Designation      ☐ Insurer Name Change      ☐ Merger / Acquisition      ☐ Update Delivery Information

**Insurer or Company Name:** \_\_\_\_\_

**Previous Name (If applicable):** \_\_\_\_\_

**Home Office Address:** \_\_\_\_\_

**City, State, Zip** \_\_\_\_\_

FEI#

FL Company Code

Telephone#

Know all men by these present, that the insurer or other entity named above is subject to the statutory agent for service of process provisions of the Florida Insurance Code duly organized and existing under and by virtue of the laws of the state of domicile.

Said entity does hereby agree and consent that actions may be commenced against it in any court having jurisdiction in any county in the State of Florida, in which a cause of action may arise, or in which the plaintiff may reside, by the service of process upon the Chief Financial Officer of the State of Florida. Said entity also hereby stipulates and agrees that any and all process so served shall be taken and held in all Courts to be as valid and binding upon this insurer or other entity as if personal service had been made upon the President or Secretary, or any other duly authorized and accredited officer thereof.

The undersigned hereby further agrees and stipulates that this agreement is and shall remain irrevocable, so long as there is liability, under any policy, claim or cause of action within this state, either fixed or contingent. Said insurer or other entity does hereby designate the following as the name and address of the person to whom all process is to be forwarded when process is served upon said Chief Financial Officer of the State of Florida on behalf of the above named insurer or entity. **In the event of a change in the name of the insurer or the designation of the person to whom process is to be forwarded, whether it be name, address, and/or phone or fax numbers, the insurer or company shall immediately file a new agreement form with the Chief Financial Officer of the State of Florida at the address shown at the bottom of this page.**

**Designated Person**

**to receive process:** \_\_\_\_\_

**E-Mail Address:** \_\_\_\_\_

**Phone#:** \_\_\_\_\_ **Fax#:** \_\_\_\_\_

**Mailing Address:** \_\_\_\_\_

**Street Address:** \_\_\_\_\_

**Signature:**

I hereby consent and agree to be the person to whom process served upon the Chief Financial Officer of the State of Florida for said entity, may be forwarded.

In Witness Whereof, we, the President or Chief Executive Officer and Secretary of said insurer or other entity, being duly authorized by the Board of Directors or governing body of this entity to execute this document, have hereunto set our hands and affixed the seal of said insurer or other entity on this the \_\_\_\_\_ day of \_\_\_\_\_, AD. \_\_\_\_\_.

SEAL

\_\_\_\_\_  
President or CEO's Signature

\_\_\_\_\_  
President or CEO's Name (Typed or Printed)

\_\_\_\_\_  
Secretary's Signature

\_\_\_\_\_  
Secretary's Name (Typed or Printed)

Any signatures other than the President, CEO, or Secretary for the Company must be validated by the attachment of a resolution of the Board of Directors or Governing body of said company delegating the authority to sign for the company.

690-203.210  
690-203.100  
690-191.107  
OIR-C1-144  
Rev 06/2004

**Service of Process Section**

200 East Gaines Street • PO Box 6200 • Tallahassee, FL 32314-6200 • (850) 413-4200 • Fax (850) 922-2544



**Office of Insurance Regulation**  
***Life & Health Financial Oversight***

**FLORIDA**

**COMPANY CODE:**

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**FEDERAL EMPLOYER**

**IDENTIFICATION NUMBER**

-----

**ANNUAL REPORT**

**OF THE**

\_\_\_\_\_  
**NAME OF THE DISCOUNT PLAN ORGANIZATION (DPO)**

\_\_\_\_\_  
**(CITY)**

\_\_\_\_\_  
**(STATE)**

**TO THE**

**OFFICE OF INSURANCE REGULATION**

**OF THE**

**STATE OF FLORIDA**

Life & Health Financial Oversight  
200 East Gaines Street  
Tallahassee, FL 32399 - 0327

**FOR THE FISCAL YEAR ENDED**

\_\_\_\_\_  
**DUE ON OR BEFORE**

**3 MONTHS AFTER THE END OF EACH FISCAL YEAR END**

**REPORT MUST BE TYPED OR PRINTED**



**Name of Discount Plan Organization (DPO):**

**Annual Report of DPO to the Florida Office of Insurance Regulation  
For Fiscal Year Ending \_\_\_\_\_**

Federal Employer Identification Number (FEIN)	_ _ _ _ _ - _ _ _ _ _		
Complete address of  DPO's principal office			
Full name & title of DPO's chief executive officer			
Web Site (s. 636.204 (4))			
Type of entity (check one)	<input type="checkbox"/> Corporation - For profit <input type="checkbox"/> Sole proprietorship <input type="checkbox"/> Corporation - Not-for-profit <input type="checkbox"/> Limited liability company <input type="checkbox"/> Partnership <input type="checkbox"/> Other:		
<p>This annual report shall be signed below by two corporate officers of the DPO, if the DPO is a corporation; the DPO's partners, if the DPO is a partnership; the DPO's owner, if the DPO is a sole proprietorship; or the DPO's managing or other duly authorized member, if the DPO is a limited liability company.</p>			
Printed name		Printed name	
Title		Title	
Signature		Signature	

Name of Discount Plan Organization (DPO): \_\_\_\_\_

**Annual Report of DPO to the Florida Office of Insurance Regulation  
For Fiscal Year Ending \_\_\_\_\_**

## **Instructions**

1. Within 3 months after the end of each fiscal year, complete and file this report for the preceding fiscal year with:

The Office of Insurance Regulation  
Life & Health Financial Oversight  
200 E. Gaines Street  
Tallahassee, Florida 32399-0327

2. Provide all requested information on page 2. Have the report signed on page 2 consistent with the instructions thereon.
3. Answer questions a through r on pages 4 and 5, as they pertain to the fiscal year covered by this report. Attach any additional information and/or documentation required as a result of your responses, clearly identifying each attachment and the question number being answered.
4. Attach a copy of the audited financial statements prepared in accordance with generally accepted accounting principles certified by an independent certified public accountant, including the organization's balance sheet, income statement, and statement of changes in cash flow for the preceding fiscal year.

An organization that is a subsidiary of a parent entity that is publicly traded and that prepares audited financial statements reflecting the consolidated operations of the parent entity and the organization may petition the office to accept, in lieu of the audited financial statement of the organization, the audited financial statement of the parent entity and a written guaranty by the parent entity that the minimum capital requirements of the organization required by this part will be met by the parent entity. The Office may accept this petition if all of the following are met:

- The licensee is 100% owned by the parent directly or indirectly
  - The parent receives an unqualified opinion
  - The parent's audited financial statement reflects at least a \$5 million net worth on a GAAP basis
  - The parent provides a parental guarantee The licensee provides un-audited financial statement on a GAAP basis attested to which reflects a surplus of \$150,000 or more.
  - Licensee requests petition in writing at least 30 days prior to due date of annual report
5. If different from the initial application or the last annual report, complete the schedule on page 7, and include the complete names, address, or Federal taxpayer identifying numbers, titles, and ownership percentages of all officers, directors, managing members, and 10% or greater owners, and for each indicate whether that individual is an officer, director, and/or owner. Please disclose the extent and nature of any contracts or arrangements between such persons and the DPO, including any possible conflicts of interest. Attach additional pages as needed.

**Name of Discount Plan Organization (DPO):**

**Annual Report of DPO to the Florida Office of Insurance Regulation  
For Fiscal Year Ending \_\_\_\_\_**

6. For each individual who, during the period covered by this report, was a member of the DPO's Board of Directors, Board of Trustees, Executive Committee, or other governing board or committee, or who was one of its principal officers or managing members, responsible for the conduct of its affairs, or in a position to exercise control or influence over its affairs, **and for whom the DPO has not previously done so**, (1) make arrangements to have an investigation report forwarded directly to the Office, and (2) attach to this report: (a) a statement informing the Office of the date that such investigative report was requested, (b) completed NAIC Biographical Statement and Affidavit, and (c) two completed Florida fingerprint cards. Only Florida fingerprint cards will be accepted. Florida fingerprint cards may be obtained by calling the Office of Insurance Regulation, L&H Financial Oversight, at (850) 413-5052.
  
7. As stated in s.636.204(3), "The office shall issue a license which shall expire 1 year later, and each year on that date thereafter, and which the office shall renew if the licensee pays the annual license fee of \$50 and if the office is satisfied that the licensee is in compliance with this part." Attach evidence of your \$50 renewal fee being paid to the Department of Financial Services, Revenue Processing Section, P.O. Box 6100, Tallahassee, Florida 32314-6100. Page 8 of this report should be detached and mailed to the address given, along with your check for \$50, **prior to the anniversary date of the DPO obtaining its license.**
  
8. Answer the questions below as they pertain to the fiscal year covered by this report. Attach any additional information and/or documentation required as a result of your responses.

		Yes	No
a	Have there been any changes to any of the DPO's basic organizational documents, such as its bylaws or articles of incorporation? If so, attach an explanation of all such changes, and copies of the amended documents.		
b	Have there been any changes in the DPO's ownership? If so, attach a statement containing complete details, and an organizational chart depicting all direct and indirect relationships between the DPO and all of its affiliates, including the ultimate parent corporation of all such entities.		
c	Was the DPO a party to any civil or criminal legal action, other than as plaintiff in a civil matter? <b>If so, attach a statement containing complete details.</b>		
d	Is the DPO doing business in any state(s) other than Florida? If so, attach a schedule of all such state(s).		
e	Was the DPO's license, registration, or certificate of authority to act as a DPO suspended or revoked by any governmental agency, or did any governmental agency initiate formal legal proceedings for said purpose? <b>If so, attach a statement containing complete details.</b>		
f	Has any governmental entity imposed fines or costs, other than normal filing fees or renewal fees, for activities arising from DPO operations? <b>If yes, attach a statement containing complete details.</b>		

**Name of Discount Plan Organization (DPO):**

**Annual Report of DPO to the Florida Office of Insurance Regulation  
For Fiscal Year Ending \_\_\_\_\_**

g	Has the DPO either maintained a surety bond in its own name, or securities eligible for deposit with Collateral Management, in an amount not less than \$35,000?		
h	Are all advertisements, marketing materials, brochures, and discount cards used by marketers approved in writing for such use by the DPO?		
i	Does the DPO have an executed written agreement with each marketer prior to the marketer's marketing, promoting, selling, or distributing the DPO?		
j	Is the DPO monitoring the content of all its websites for compliance with s.636.210, s.636.212, and s.636.226 Florida Statutes?		
k	Did the DPO fail to pay any judgment rendered, if any, against it in any state within 60 days after the judgment became final? <b>If so, attach a statement containing complete details.</b>		
l	Was the DPO at any time unable to fully pay when due any debts, or to timely meet any other obligations: <b>If so, attach a statement containing complete details.</b>		
m	Was the DPO or any of its owners, officers, or directors, convicted of, or did it (or that person) enter a plea of guilty or nolo contendere to a felony in any state without regard to whether adjudication was withheld? <b>If so, attach a statement containing complete details.</b>		

		<b>Florida</b>
n	For the year covered by this report, what was the total amount of revenue collected for Florida DPO business?	\$
o	How many residents of Florida are members of the DPO?	
p	List the internet websites used by the DPO and its marketers.	

Name of Discount Plan Organization (DPO): \_\_\_\_\_

Annual Report of DPO to the Florida Office of Insurance Regulation  
For Fiscal Year Ending \_\_\_\_\_

**CHECK LIST**

**Please indicate by checking the boxes that each action has been taken**

- ☐ This Report has been completed in its entirety with all schedules.
- ☐ Audited CPA financial statements and Opinion Letter are attached.
- ☐ Separate responses, cross-referenced to the question, are attached where appropriate.
- ☐ All financial statements and schedules are mathematically correct.
- ☐ If required, biographical statements, background investigative reports, and fingerprint cards
- ☐ Evidence of payment of license renewal fee.
- ☐ Requests for clarification may be sent electronically to the e-mail address below.

**The person to contact regarding any information contained in this report is:**

\_\_\_\_\_  
(name & position / title)

\_\_\_\_\_  
(address)

\_\_\_\_\_  
(city, state, zip)

( \_\_\_\_ ) \_\_\_\_ - \_\_\_\_ EXT: \_\_\_\_  
(area code - telephone number - extension)

( \_\_\_\_ ) \_\_\_\_ - \_\_\_\_  
(area code - fax number)

\_\_\_\_\_  
(e-mail, if applicable)

**Annual Report of DPO to the Florida Office of Insurance Regulation  
For Fiscal Year Ending \_\_\_\_\_**



**Office of Insurance Regulation**  
**Life & Health Financial Oversight**

**REMITTANCE FORM**

**Detach and separately forward this page prior to the due date of the required license renewal with your payment to the address below.**

Name of Discount Plan Organization	
Street address	
City, State, Zip	
Federal Employer Identification Number	__ __ -- __ __ __ __ __ __
Florida Company Code	__ __ __ __
Renewal Date of License	_____ <b>20</b> __ __

ATTACH CHECK FOR \$50.00 HERE.

MAKE CHECK PAYABLE TO  
DEPARTMENT OF FINANCIAL SERVICES

MAIL PAYMENT & THIS PAGE TO:

DEPARTMENT OF FINANCIAL SERVICES  
REVENUE PROCESSING SECTION  
P. O. BOX 6100  
TALLAHASSEE, FLORIDA 32314-6100

**FOR OFFICE OF INSURANCE REGULATION USE ONLY**

AMOUNT	TYPE/CLASS	FEE	FUND ACCOUNT
\$50.00	1300	L	Renewal License Fee



**Office of Insurance Regulation**  
**Company Admissions**

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**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

**The Office receives applications electronically. Please submit your application at <http://www.floir.com/iportal>, using the iApply link to Online Company Admissions.**

This package is designed to assist individuals in preparing the application with all the information required by statute and to facilitate expeditious processing of the application by this Office.

PLEASE NOTE: THE COMPLETED CHECK LIST MUST BE SUBMITTED WITH THE APPLICATION PACKAGE.

The completed application package must be submitted to the Office by utilizing the following link:

**<http://www.floir.com/iportal>**  
and select iApply – Online Company Admissions

If this package requires submission of forms and/or rates, upon receipt of an email notification of acceptance of the application, the Applicant is directed to return to the Industry Portal <http://www.floir.com/iportal> and select "Form & Rate Filing Assembly and Submission" to begin the submission of forms and/or rates.

If this package requires original documents, in lieu of providing original paper documents, the Applicant is directed to submit a PDF of the original document(s) unless otherwise required by Florida Statutes.

Any questions concerning this application package may be directed to the Application Coordinator at [appcoord@floir.com](mailto:appcoord@floir.com). For iApply only questions, contact the Application Coordinator at [iapply@floir.com](mailto:iapply@floir.com)

**In order for a submission to be considered a complete application, all required information must be included in the filing. Filings that do not include all required information will be disapproved or returned.**



**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

Pursuant to Section 636.Part II, Florida Statutes, in order to do business as a Discount Plan Organization (DPO), an entity must:

- A. Be a corporation, a limited liability company, or a limited partnership, incorporated, organized, formed, or registered under the laws of this state or authorized to transact business in this state in accordance with Chapter 605, Part I of Chapter 607, Chapter 617, Chapter 620, or Chapter 865, F.S., and must be licensed by the Office as a discount plan organization or be licensed by the Office pursuant to Chapter 624, Part I of Chapter 636, or Chapter 641, F.S.  
[s., 636.204(1), F.S.];
- B. Be an entity, which in exchange for fees, dues, charges, or other consideration, provides access for plan members to providers of medical services and the right to receive medical services from those providers at a discount. [s.636.202(2), F.S.];

**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

**INSTRUCTIONS  
SECTION I - APPLICATION FEES AND FORM**

**Section I-1    Application Fee**

The application filing fee is \$50.00. The initial fee is due and payable at the time of filing the application for licensure. [s.636.204(2)(l) and s.636.204(5), F.S.]

Secure the check to the invoice, which is included in this package, and send to:

Florida Department of Financial Services  
Revenue Processing Section  
P.O. Box 6100  
Tallahassee, Florida 32314-6100

Submit a copy of the invoice and a copy of the check with your application filing. This procedure will expedite the processing of your application and assure a timely recording of the fees.

**Section I-2    Fingerprint Processing Fees**

Applicants are required to prepay electronically for the processing of the fingerprint cards required in Section IV-4. Please see Form OIR-C1-938 for instructions.

Florida residents have the option of having their fingerprints digitally scanned rather than providing paper fingerprint cards. Please see form OIR-C1-938 for instructions.

**Section I-3    Application for License (Official Form included with this package)**

This form must be sworn to by an officer or authorized representative of the applicant.

**SECTION II-LEGAL**

**Section II-1    Articles of Incorporation**

Include in this section the applicant's Articles of Incorporation or other organizing documents, including all amendments. The required filings must be recently certified by the official public records custodian in the applicant's state of domicile. The certification letter must be an original. [s.636.204(2)(a), F.S.]

**Section II-2    Certificate of Status from Florida Secretary of State**

Provide a Certificate of Status document issued by the Florida Secretary of State which certifies that the applicant is authorized in this State and that all state taxes and fees

**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

have been paid. This certificate must be obtained from the Florida Secretary of State's office and be an original. [s.636.204(1), F.S.]

If you have any questions concerning filing with the Secretary of State, please contact the Division of Corporations at (850) 245-6051 or see <http://www.sunbiz.org/>.

Important note: The Secretary of State will issue a charter to a discount plan organization before the Office completes its processing of an application for a license. This charter authorizes the company to engage in any type of business except insurance or discount plans, or other regulated business.

**Your company MAY NOT engage in the business of a discount plan in Florida until it has been issued a license by the Commissioner of the Office.**

**Section II-3 By-Laws, Constitution, or Rules and Regulations**

Include a copy of the applicant's By-Laws, Constitution, and/or Rules and Regulations in this section. The bylaws must be signed, and recently dated by the Secretary of the company. No signature other than the Secretary's will be accepted. [s. 636.204(2)(b), F.S.]

**Section II-4 Certificate of Compliance (Foreign Applicants Only)**

If applicable, provide a Certificate of Compliance issued by the public official having supervision in applicant's state of domicile showing that the company is organized and authorized to issue contracts and the kinds of contracts it is authorized to transact. The certificate should be an original under seal by the organization's state of domicile. If not applicable, please state this in the application.

**Section II-5 Service of Process Form**

**[s.636.234, 624.422 and 624.423 F.S.]**

Provide an executed Service of Process Consent and Agreement form (official form included in this package) under corporate seal and signed by the president or chief executive officer and secretary.

**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

**SECTION III - FINANCIAL AND RELATED INFORMATION**

**Section III-1      Marketing and Growth**

Submit a description of the proposed method of marketing, including the target groups, types of discounts to be offered, and advertising media to be used.  
[s. 636.204(2)(j), F.S.]

**Section III-2      Advertising**

Provide a description of the procedures in place for the DPO to approve advertising, prior to use, pursuant to Section 636.228, Florida Statutes.

**Section III-3      Website**

Prior to licensure by the Office, each DPO must establish an Internet website that conforms to the requirements of Section 636.226, Florida Statutes. [s. 636.204(4)] This website should also comply with the disclosures required in s. 636.212, F.S. and should not include any prohibitions listed in s. 636.210, F.S.

Provide the address of the website that complies with these statutes.

**Section III-4      Financial**

A.    Submit a copy of the applicant's most recent financial statements audited by an independent certified public accountant [s.636.204,(2)(i), F.S.], and provide the date of the company's fiscal year end.

B.    Each DPO must at all times maintain a net worth of at least \$150,000.  
[s.636.220(1), F.S.]

The OFFICE may not issue a license unless the DPO has a net worth of at least \$150,000.  
[s.636.220(2), F.S.]

C.    Documentation that the applicant has complied with the surety bond or security deposit requirements [636.236(1), Florida Statutes]. For security deposits, contact the Bureau of Collateral Management at (850) 413-3167.

(1) Each DPO must maintain in force (unless deposit is placed in lieu of the bond) a surety bond in its own name in an amount not less than \$35,000 to be used at the discretion of the Office to protect the financial interest of members who may be adversely affected by the insolvency of a DPO. The bond must be issued by an insurance company that is licensed to do business in this state.

**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

- (2) In lieu of #1 above, each DPO shall deposit with the Bureau of Collateral Management cash or securities of the type eligible under Section 625.52, Florida Statutes, which shall have at all times a market value of \$35,000.
- (3) If for any reason the market value of assets and securities of DPO held on deposit in this state falls below the amount required, the organization shall promptly deposit other or additional assets or securities eligible for deposit sufficient to cure the deficiency.

**Section III-5 Contractual**

- A. A copy of the form of all contracts made or to be made between the applicant and any providers or provider networks regarding the provision of medical services to members. [s. 636.204(2)(f), F.S.]
- B. A copy of the form of any contract made or to be made between the applicant and any person, corporation, partnership, or other entity for the performance on the applicant's behalf of any function including, but not limited to, marketing, administration, enrollment, investment management, and subcontracting for the provision of health services to members. [s. 636.204(2)(h), F. S.]
- C. A copy of the form of any contract made or arrangement to be made between the applicant and any person listed in the Management Section (Section IV) of this application as individuals who are responsible for conducting the applicant's affairs, including but not limited to, all members of the board of directors, board of trustees, executive committee, or other governing board or committee, the officers, contracted management company personnel, and any person or entity owning or having the right to acquire 10% or more voting securities of the applicant. [s. 636.204(2)(c) and (g), F.S.]

**Section III-6** A statement generally describing the applicant, its facilities and personnel, and the medical services to be offered. [s. 636.204(2)(e), F.S.]

**Section III-7** A description of the subscriber complaint procedures to be established and maintained. [ s. 636.204,(2)(k), F.S.]

**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

**SECTION IV - MANAGEMENT**

**NAMES REQUESTED IN THIS SECTION SHOULD INCLUDE COMPLETE FIRST, MIDDLE AND LAST NAMES.**

**Section IV-1    List of All Officers, Directors, and Shareholders [s.636.204(2)(c) F.S.]**

- A.    List the names, addresses and official positions of each officer, director and any person having direct or indirect control of the organization, including but not limited to contracted management company personnel (form included in this package).
- B.    List the names of each shareholder owning ten percent or more of voting securities of the applicant or any person having the right to acquire ten percent or more of the voting securities of the applicant (issued and outstanding warrants/options, etc.). Such persons shall fully disclose to the Office and to the directors the extent and nature of any contracts or arrangements between them and the DPO, including any possible conflicts of interest.
- C.    If the applicant is a subsidiary of a parent or holding company, provide an organizational chart showing the relationship of all related companies.

**Section IV-2    Biographical Affidavits for Officers, Directors and Shareholders [s.636.204(2)(d),F.S.]**

Provide a Biographical Affidavit (Form OIR-C1-1423) for each officer, director, any person having direct or indirect control of the organization, including but not limited to contracted management company personnel and shareholder listed in Section IV-1 except for those companies in the organizational structure between the immediate parent and the ultimate parent. All questions must be answered. All "Yes" answers must be explained.

Each biographical affidavit must contain an original signature and original notary seal.

The requirement for the affiant's social security number as part of the Biographical Affidavit is mandatory. However, pursuant to Sections 119.071(5), Florida Statutes, social security numbers collected by an agency are confidential and exempt from Section 119.07(1), Florida Statutes, and Section 24(a), Art. I of the State Constitution and must be segregated on a separate page. Therefore, instead of including the SSN on the Biographical Affidavit, please include the affiant's name and social security number on a separate page and attach it to the Biographical Affidavit. Also please mark CONFIDENTIAL at the top and bottom of the separate page.

Section 119.071(5), Florida Statutes, gives authority for an agency to collect social security numbers if imperative for the performance of that agency's duties and

**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

responsibilities as prescribed by law. Limited collection of social security numbers is imperative for the Office. The duties of the Office in background investigation are extensive in order to ensure that the owners, management, officers, and directors of any insurer are competent and trustworthy, possess financial standing and business experience, and have not been found guilty of, or not pleaded guilty or nolo contendere to, any felony or crime punishable by imprisonment of one year.

**Section IV-3     Investigative Background Reports [636.204(2)(d) F.S.]**

A Background Investigative Report must be provided for each person listed in Section IV-1 above except for those companies in the organizational structure between the immediate parent and the ultimate parent. Background reports must be submitted by the selected background investigator vendor prior to or contemporaneously with the application filing. Please refer to form OIR-C1-905 REV 02/15 for instructions.

**Section IV-4     Fingerprint Cards**

Fingerprint cards must be completed for each person listed in Section IV-1. The cards will be furnished by the Office upon request. **No cards other than those furnished by the Office will be accepted.** The cards must be completed at a law enforcement agency and returned to this Office for processing. Please refer to Form OIR-C1-938 for instructions.

Florida residents have the option of having their fingerprints digitally scanned rather than providing paper fingerprint cards and fees as noted above. Please refer to Form OIR-C1-938.

**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

**CHECK LIST  
SECTION I - APPLICATION FEES AND FORM**

Company Name: \_\_\_\_\_

<u>Item #</u>	<u>Completion Check List</u>
1. Insurer application fees paid.....	<input type="checkbox"/>
(a) Copy of invoice included (Official Form).....	<input type="checkbox"/>
(b) Copy of check.....	<input type="checkbox"/>
(c) Originals mailed to Revenue Processing Section.....	<input type="checkbox"/>
2. Fingerprint fee paid electronically.....	<input type="checkbox"/>
a. Copy of on-line payment confirmation.....	<input type="checkbox"/>
3. Application for License (Official Form).....	<input type="checkbox"/>
(a) All blanks completed.....	<input type="checkbox"/>
(b) If applicable, sealed by corporation.....	<input type="checkbox"/>
(c) Signed by President or other authorized officer (original signature).....	<input type="checkbox"/>



**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

**SECTION II – LEGAL**

Company Name: \_\_\_\_\_

<u>Item #</u>	<u>Completion Check List</u>
1. Articles of Incorporation or other organizing documents and all amendments attached with an original certification by the State of Domicile .....	<input type="checkbox"/>
2. Certificate of Status from Florida Secretary of State (original document) .....	<input type="checkbox"/>
(a) Good standing indicated.....	<input type="checkbox"/>
(b) Sealed by state.....	<input type="checkbox"/>
(c) Signed by proper public official.....	<input type="checkbox"/>
(d) Original.....	<input type="checkbox"/>
3. Corporate By-Laws, Rules and Regulations, and/or Constitution .....	<input type="checkbox"/>
(a) Signed and dated by applicant's secretary.....	<input type="checkbox"/>
4. Certificate of Compliance from State of domicile.....	<input type="checkbox"/>
(a) Original Certification from State of domicile.....	<input type="checkbox"/>
(b) Form indicates the kinds of contracts the company is authorized to transact.....	<input type="checkbox"/>
(c) Not applicable.....	<input type="checkbox"/>
5. Service of Process Form.....	<input type="checkbox"/>

**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

**SECTION III - FINANCIAL AND RELATED INFORMATION**

Company Name: \_\_\_\_\_

<u>Item #</u>	<u>Completion Check List</u>
1. Marketing and growth .....	<input type="checkbox"/>
(a) Description of marketing methods.....	<input type="checkbox"/>
2. Advertising.....	<input type="checkbox"/>
(a) Include a description of advertising procedures.....	<input type="checkbox"/>
3. Provide website address.....	<input type="checkbox"/>
4. Financial .....	<input type="checkbox"/>
A. Current audited financial statements & fiscal year end date...	<input type="checkbox"/>
B. Compliance with minimum surplus requirement.....	<input type="checkbox"/>
C. Original document evidencing compliance with surety bond requirement or security deposit requirement as explained in S.III-4C 1&2 .....	<input type="checkbox"/>
5. Contractual Documents .....	<input type="checkbox"/>
(a) Provider contract form .....	<input type="checkbox"/>
(b) Other forms of contracts per s.636.204(2)(h), F.S.....	<input type="checkbox"/>
(c) Other forms of contracts per s.636.204(2)(c) and (g), F.S.....	<input type="checkbox"/>
6. Statement describing facilities, personnel, and medical services...	<input type="checkbox"/>
7. Description of subscriber complaint procedures.....	<input type="checkbox"/>

**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

**SECTION IV – MANAGEMENT**

**Note:** This portion of the checklist is detailed in order to assist the applicant in ensuring all items are completed, and checklist item numbers will not correlate with item numbers in the Instructions.

<u>Item #</u>		<u>Completion Check List</u>
1.	Listing of all officers, directors, and shareholders (including entities owning 10% or more of applicant (Form OIR-C1-1298) .....	<input type="checkbox"/>
2.	Listing of all <u>immediate</u> parent(s) officers, directors, and shareholders (including entities) owning 10% or more of parent company's stock (Form OIR-C1-1298) .....	<input type="checkbox"/>
3.	Listing of all <u>intermediary</u> parent(s) (between immediate parent(s) and ultimate parent(s)), officers and shareholders (including entities) owning 10% or more of parent company's stock (Form OIR-C1-1298). Note, do not complete Form OIR-C1-1423, (Biographical Affidavits) or order investigative reports or fingerprint cards.....	<input type="checkbox"/>
4.	Listing of all <u>ultimate</u> parent(s) officers, directors, and shareholders (including entities) owning 10% or more of parent company's stock (Form OIR-C1-1298) .....	<input type="checkbox"/>
5.	Organizational Chart including all entities within the ultimate parent company structure.....	<input type="checkbox"/>
6.	Biographical Affidavits for company officers, directors, and shareholders (including entities) owning 10% or more of applicant (Form OIR-C1-1423) .....	<input type="checkbox"/>
<b>As to each biographical:</b>		
(a)	All blanks completed.....	<input type="checkbox"/>
(b)	Contains original signature .....	<input type="checkbox"/>
(c)	Notarized (original) .....	<input type="checkbox"/>
(d)	SSN on a separate page.....	<input type="checkbox"/>

**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

**SECTION IV – MANAGEMENT  
Required Filing and Check list**

7. Biographical Affidavits for immediate parent(s) officers, directors, and shareholders (including entities) owning 10% or more of parent Company's stock (Form OIR-C1-1423) ..... ☐
- As to each biographical:**
- (a) All blanks completed..... ☐
- (b) Contains original signature..... ☐
- (c) Notarized (original)..... ☐
- (d) SSN on a separate page..... ☐
8. Biographical Affidavits for ultimate parent(s) officers, directors, and Shareholders (including entities) owning 10% or more of parent company's Stock (Form OIR-C1-1423)
- As to each biographical:**
- (a) All blanks completed..... ☐
- (b) Contains original signature..... ☐
- (c) Notarized (original)..... ☐
- (d) SSN on a separate page..... ☐
9. Background investigative reports for company officers, directors, and shareholders (including entities) owning 10% or more of applicant..... ☐
10. Background Investigative reports for immediate parent(s) officers, directors and shareholders (including entities) owning 10% or more of parent company's stock..... ☐
11. Background Investigative reports for ultimate parent(s) officers, directors and shareholders (including entities) owning 10% or more of parent company's stock..... ☐

**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

**Note:** If fingerprints are digitally scanned, Items 12, 13 and 14 are not applicable.

12. Fingerprint cards completed for each company officer, director, and shareholder (including entities) owning 10% or more of applicant ..... ☐

**As to each fingerprint card:**

- (a) Contains original signature..... ☐
- (b) Florida cards only..... ☐
- (c) All information completed (DOB, citizenship, vital statistics, SSN on a separate page) ..... ☐

13. Fingerprint cards completed for each immediate parent(s) officer, director, and shareholder (including entities) owning 10% or more of parent company's stock..... ☐

**As to each fingerprint card:**

- (a) Contains original signature..... ☐
- (b) Florida cards only..... ☐
- (c) All information completed (DOB, citizenship, vital statistics, SSN on a separate page) ..... ☐

14. Fingerprint cards completed for each ultimate parent(s) officer, director, and shareholder (including entities) owning 10% or more of parent company's stock..... ☐

- (a) Contains original signature..... ☐
- (b) Florida cards only..... ☐
- (c) All information completed (DOB, citizenship, vital statistics, SSN on a separate page)..... ☐

**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

**CHECKLIST VERIFICATION**

The undersigned says that he/she is a senior officer having personal knowledge of the application submitted to the Florida Office of Insurance Regulation in connection with licensure sought by (Entity Name)\_\_\_\_\_ that he/she has read said application, that he/she knows the contents thereof and verifies that the items indicated in the application checklist have been submitted with the application, that he/she executed the same in his/her authorized capacity, and that by his/her signature on the instrument, the applicant on behalf which the person acted, executed the instrument.

I understand that whoever knowingly makes a false statement in writing with the intent to mislead a public servant in the performance of his or her official duties is guilty of a misdemeanor of the second degree, pursuant to Section 837.06, Florida Statutes.

Dated \_\_\_\_\_  
(Give full and exact name of applicant)

\_\_\_\_\_  
Signature of President, Secretary, or Treasurer

\_\_\_\_\_  
Printed Name

\_\_\_\_\_  
Printed Title

**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

Pursuant to Chapter 636, Part II Florida Statutes, application is hereby submitted to form and operate a Discount Plan Organization.

In order to qualify as a Discount Plan Organization (DPO), an entity must:

- A. Be a corporation, a limited liability company, or a limited partnership, incorporated, organized, formed, or registered under the laws of this state or authorized to transact business in this state in accordance with Chapter 605, part I of Chapter 607, Chapter 617, Chapter 620, or Chapter 865, F.S., and must be licensed by the Office as a discount plan organization or be licensed by the Office pursuant to Chapter 624, Part I of Chapter 636, or Chapter 641, F.S. [s., 636.204(1), F.S.];
- B. Be an entity which, in exchange for fees, dues, charges, or other consideration, provides access for plan members to providers of medical services and the right to receive medical services from those providers at a discount. [s.636.202(2), F.S.];

Proposed name of Discount Plan Organization:

NAME: \_\_\_\_\_

ADDRESS: \_\_\_\_\_

CITY: \_\_\_\_\_ STATE: \_\_\_\_\_ ZIP CODE: \_\_\_\_\_

FEDERAL IDENTIFICATION NUMBER: \_\_\_\_\_

PHONE: \_\_\_\_\_

CONTACT PERSON: \_\_\_\_\_

E-MAIL: \_\_\_\_\_ FAX: \_\_\_\_\_

ATTORNEY OR PRINCIPAL FILING THIS APPLICATION:

NAME: \_\_\_\_\_

ADDRESS: \_\_\_\_\_

CITY: \_\_\_\_\_ STATE: \_\_\_\_\_ ZIP CODE: \_\_\_\_\_

PHONE: \_\_\_\_\_ E-MAIL: \_\_\_\_\_ FAX: \_\_\_\_\_

**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

This company, through its duly authorized officers, hereby applies for a license authorizing and empowering it to operate as a discount plan organization in the state of Florida, under the laws thereof, and do hereby swear or affirm that all of the responses, information, exhibits, and documentary evidence submitted in support of this application are true and correct.

Signed this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_\_.

\_\_\_\_\_  
President or other authorized officer  
(Please print)

\_\_\_\_\_  
Signature

(Corporate Seal)

State of \_\_\_\_\_

County of \_\_\_\_\_

Sworn to and subscribed before me this \_\_\_\_\_ day of \_\_\_\_\_ 20\_\_\_\_\_.

(Notary Seal)

\_\_\_\_\_  
Notary Public

\_\_\_\_\_  
My Commission Expires



**APPLICATION FOR LICENSE  
DISCOUNT PLAN ORGANIZATION (DPO)**

**INVOICE  
PAYMENT OF APPLICATION FEE**

NAME OF COMPANY: \_\_\_\_\_

FEIN #: \_\_\_\_\_

ADDRESS: \_\_\_\_\_

CITY, STATE & ZIP CODE: \_\_\_\_\_

PHONE NUMBER: \_\_\_\_\_

ADDRESS (IF DIFFERENT FROM STREET ADDRESS)

\_\_\_\_\_

\_\_\_\_\_ (CITY) (STATE) (ZIP CODE)

E-MAIL ADDRESS: \_\_\_\_\_ FAX: \_\_\_\_\_

In reference to the recent submission by the above-referenced discount ~~medical~~ plan organization regarding its application to do business in Florida, it is necessary that you return this form with the proper payment as listed below.

**PLEASE NOTE:**

1. Send a check in the proper amount made payable to the Florida Department of Financial Services and mail check and invoice only to the Florida Department of Financial Services, Revenue Processing Section, P.O. Box 6100, Tallahassee, Florida 32314-6100.
2. Include a copy of the check and invoice with the application filing submitted electronically via iApply.

If you have any questions, please contact Applications Coordination at (850) 413-2575.

	<u>B/T</u>	<u>TY/CL</u>	<u>F/T</u>	<u>AMOUNT</u>
Filing Fee	C	1249F	F	\$ 50.00

## BIOGRAPHICAL AFFIDAVIT

To the extent permitted by law, this affidavit will be kept confidential by the state insurance regulatory authority. The affiant may be required to provide additional information during the third-party verification process if they have attended a foreign school or lived and worked internationally.

(Print or Type)

Full name, address and telephone number of the present or proposed entity under which this biographical statement is being required (Do Not Use Group Names). \_\_\_\_\_

In connection with the above-named entity, I herewith make representations and supply information about myself as hereinafter set forth. (Attach addendum or separate sheet if space hereon is insufficient to answer any question fully.) IF ANSWER IS "NO" OR "NONE," SO STATE.

1. Affiant's Full Name (Initials Not Acceptable): First: \_\_\_\_\_ Middle: \_\_\_\_\_ Last: \_\_\_\_\_

2. a. Are you a citizen of the United States?

Yes ☐ No ☐

b. Are you a citizen of any other country?

Yes ☐ No ☐

If yes, what country? \_\_\_\_\_

3. Affiant's occupation or profession: \_\_\_\_\_

4. Affiant's business address: \_\_\_\_\_

Business telephone: \_\_\_\_\_ Business Email: \_\_\_\_\_

5. Education and training:

<u>College/University</u>	<u>City/State</u>	<u>Dates Attended (MM/YY)</u>	<u>Degree Obtained</u>
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<u>Graduate Studies</u>	<u>College/University</u>	<u>City/State</u>	<u>Dates Attended (MM/YY)</u>	<u>Degree Obtained</u>
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<u>Other Training: Name</u>	<u>City/State</u>	<u>Dates Attended (MM/YY)</u>	<u>Degree/Certification Obtained</u>
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Note: If affiant attended a foreign school, please provide full address and telephone number of the college/university. If applicable, provide the foreign student Identification Number and/or attach foreign diploma or certificate of attendance to the Biographical Affidavit Personal Supplemental Information.

Applicant Company Name : \_\_\_\_\_

NAIC No. \_\_\_\_\_

FEIN: \_\_\_\_\_

6. List of memberships in professional societies and associations:

<u>Name of Society/Association</u>	<u>Contact Name</u>	<u>Address of Society/Association</u>	<u>Telephone Number of Society/Association</u>
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_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

7. Present or proposed position with the Applicant Company: \_\_\_\_\_

8. List complete employment record for the past twenty (20) years, whether compensated or otherwise (up to and including present jobs, positions, partnerships, owner of an entity, administrator, manager, operator, directorates or officerships). Please list the most recent first. Attach additional pages if the space provided is insufficient. It is only necessary to provide telephone numbers and supervisory information for the past ten (10) years. Additional information may be required during the third-party verification process for international employers.

Beginning/Ending  
Dates (MM/YY): \_\_\_\_\_ - \_\_\_\_\_ Employer's Name: \_\_\_\_\_

Address: \_\_\_\_\_ City: \_\_\_\_\_ State/Province: \_\_\_\_\_

Country: \_\_\_\_\_ Postal Code: \_\_\_\_\_ Phone: \_\_\_\_\_ Offices/Positions Held: \_\_\_\_\_

Type of Business: \_\_\_\_\_ Supervisor/Contact: \_\_\_\_\_

Beginning/Ending  
Dates (MM/YY): \_\_\_\_\_ - \_\_\_\_\_ Employer's Name: \_\_\_\_\_

Address: \_\_\_\_\_ City: \_\_\_\_\_ State/Province: \_\_\_\_\_

Country: \_\_\_\_\_ Postal Code: \_\_\_\_\_ Phone: \_\_\_\_\_ Offices/Positions Held: \_\_\_\_\_

Type of Business: \_\_\_\_\_ Supervisor/Contact: \_\_\_\_\_

Beginning/Ending  
Dates (MM/YY): \_\_\_\_\_ - \_\_\_\_\_ Employer's Name: \_\_\_\_\_

Address: \_\_\_\_\_ City: \_\_\_\_\_ State/Province: \_\_\_\_\_

Country: \_\_\_\_\_ Postal Code: \_\_\_\_\_ Phone: \_\_\_\_\_ Offices/Positions Held: \_\_\_\_\_

Type of Business: \_\_\_\_\_ Supervisor/Contact: \_\_\_\_\_

Beginning/Ending  
Dates (MM/YY): \_\_\_\_\_ - \_\_\_\_\_ Employer's Name: \_\_\_\_\_

Address: \_\_\_\_\_ City: \_\_\_\_\_ State/Province: \_\_\_\_\_

Country: \_\_\_\_\_ Postal Code: \_\_\_\_\_ Phone: \_\_\_\_\_ Offices/Positions Held: \_\_\_\_\_

Type of Business: \_\_\_\_\_ Supervisor/Contact: \_\_\_\_\_

9. a. Have you ever been in a position which required a fidelity bond?

Yes ☐ No ☐

If any claims were made on the bond, give details: \_\_\_\_\_

- b. Have you ever been denied an individual or position schedule fidelity bond, or had a bond canceled or revoked?

Yes ☐ No ☐

If yes, give details: \_\_\_\_\_

10. List any professional, occupational and vocational licenses (including licenses to sell securities) issued by any public or governmental licensing agency or regulatory authority or licensing authority that you presently hold or have held in the past. For any non-insurance regulatory issuer, identify and provide the name, address and telephone number of the licensing authority or regulatory body having jurisdiction over the license (s) issued. If your professional license number is your Social Security Number (SSN) or embeds your SSN or any sequence of more than five numbers that are reasonably identifiable as your SSN, then write SSN for that portion of the professional license number that is represented by your SSN. (For example, "SSN", "12-SSN-345" or "1234-SSN" (last 6 digits)). Attach additional pages if the space provided is insufficient.

Organization/Issuer of License: \_\_\_\_\_ Address: \_\_\_\_\_

City: \_\_\_\_\_ State/Province: \_\_\_\_\_ Country: \_\_\_\_\_ Postal Code: \_\_\_\_\_

License Type: \_\_\_\_\_ License #: \_\_\_\_\_ Date Issued (MM/YY): \_\_\_\_\_

Date Expired (MM/YY): \_\_\_\_\_ Reason for Termination: \_\_\_\_\_

Non-Insurance Regulatory Phone Number (if known): \_\_\_\_\_

Organization/Issuer of License: \_\_\_\_\_ Address: \_\_\_\_\_

City: \_\_\_\_\_ State/Province: \_\_\_\_\_ Country: \_\_\_\_\_ Postal Code: \_\_\_\_\_

License Type: \_\_\_\_\_ License #: \_\_\_\_\_ Date Issued (MM/YY): \_\_\_\_\_

Date Expired (MM/YY): \_\_\_\_\_ Reason for Termination: \_\_\_\_\_

Non-Insurance Regulatory Phone Number (if known): \_\_\_\_\_

11. In responding to the following, if the record has been sealed or expunged, and the affiant has personally verified that the record was sealed or expunged, an affiant may respond "no" to the question. Have you ever:

- a. Been refused an occupational, professional, or vocational license or permit by any regulatory authority, or any public administrative, or governmental licensing agency?

Yes ☐ No ☐

Applicant Company Name : \_\_\_\_\_

NAIC No. \_\_\_\_\_  
FEIN: \_\_\_\_\_

- b. Had any occupational, professional, or vocational license or permit you hold or have held, been subject to any judicial, administrative, regulatory, or disciplinary action?  
Yes ☐ No ☐
- c. Been placed on probation or had a fine levied against you or your occupational, professional, or vocational license or permit in any judicial, administrative, regulatory, or disciplinary action?  
Yes ☐ No ☐
- d. Been charged with, or indicted for, any criminal offense(s) other than civil traffic offenses?  
Yes ☐ No ☐
- e. Pled guilty, or nolo contendere, or been convicted of, any criminal offense(s) other than civil traffic offenses?  
Yes ☐ No ☐
- f. Had adjudication of guilt withheld, had a sentence imposed or suspended, had pronouncement of a sentence suspended, or been pardoned, fined, or placed on probation, for any criminal offense(s) other than civil traffic offenses?  
Yes ☐ No ☐
- g. Been subject to a cease and desist letter or order, or enjoined, either temporarily or permanently, in any judicial, administrative, regulatory, or disciplinary action, from violating any federal, state law or law of another country regulating the business of insurance, securities or banking, or from carrying out any particular practice or practices in the course of the business of insurance, securities or banking?  
Yes ☐ No ☐
- h. Been, within the last ten (10) years, a party to any civil action involving dishonesty, breach of trust, or a financial dispute?  
Yes ☐ No ☐
- i. Had a finding made by the Comptroller of any state or the Federal Government that you have violated any provisions of small loan laws, banking or trust company laws, or credit union laws, or that you have violated any rule or regulation lawfully made by the Comptroller of any state or the Federal Government?  
Yes ☐ No ☐
- j. Had a lien or foreclosure action filed against you or any entity while you were associated with that entity?  
Yes ☐ No ☐

If the response to any question above is yes, please provide details including dates, locations, disposition, etc. Attach a copy of the complaint and filed adjudication or settlement as appropriate.

\_\_\_\_\_  
\_\_\_\_\_

12. List any entity subject to regulation by an insurance regulatory authority that you control directly or indirectly. The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person,

whether through the ownership of voting securities, by contract other than a commercial contract for goods or non-management services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, ten percent (10%) or more of the voting securities of any other person.

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If any of the stock is pledged or hypothecated in any way, give details.

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13. Do [Will] you or members of your immediate family individually or cumulatively subscribe to or own, beneficially or of record, 10% or more of the outstanding shares of stock of any entity subject to regulation by an insurance regulatory authority, or its affiliates? An "affiliate" of, or person "affiliated" with, a specific person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

Yes ☐ No ☐

If yes, please identify the company or companies in which the cumulative stock holdings represent 10% or more of the outstanding voting securities.

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If any of the shares of stock are pledged or hypothecated in any way, give details.

---

14. Have you ever been adjudged a bankrupt?

Yes ☐ No ☐

If yes, provide details:

---

15. To your knowledge has any company or entity for which you were an officer or director, trustee, investment committee member, key management employee or controlling stockholder, had any of the following events occur while you served in such capacity?

- a. Been refused a permit, license, or certificate of authority by any regulatory authority, or governmental-licensing agency?

Yes ☐ No ☐

- b. Had its permit, license, or certificate of authority suspended, revoked, canceled, non-renewed, or subjected to any judicial, administrative, regulatory, or disciplinary action (including rehabilitation, liquidation, receivership, conservatorship, federal bankruptcy proceeding, state insolvency, supervision or any other similar proceeding)?

Yes ☐ No ☐

- c. Been placed on probation or had a fine levied against it or against its permit, license, or certificate of authority in any civil, criminal, administrative, regulatory, or disciplinary action?

Yes ☐ No ☐

Applicant Company Name : \_\_\_\_\_

NAIC No. \_\_\_\_\_

FEIN: \_\_\_\_\_

If the answer to any of the above is yes, please indicate and give details. When responding to questions (b) and (c), affiant should also include any events within twelve (12) months after his or her departure from the entity. \_\_\_\_\_

Note: If an affiant has any doubt about the accuracy of an answer, the question should be answered in the positive and an explanation provided.

Dated and signed this \_\_\_\_\_ day of \_\_\_\_\_ 20\_\_\_\_ at \_\_\_\_\_. I hereby certify under penalty of perjury that I am acting on my own behalf and that the foregoing statements are true and correct to the best of my knowledge and belief.

\_\_\_\_ I hereby acknowledge that I may be contacted to provide additional information regarding international searches.

\_\_\_\_\_  
(Signature of Affiant)

State of: \_\_\_\_\_ County of: \_\_\_\_\_

The foregoing instrument was acknowledged before me this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_ by \_\_\_\_\_, and:

☐ who is personally known to me, or

☐ who produced the following identification: \_\_\_\_\_

[SEAL]

\_\_\_\_\_  
Notary Public

\_\_\_\_\_  
Printed Notary Name

\_\_\_\_\_  
My Commission Expires

**BIOGRAPHICAL AFFIDAVIT**  
**Supplemental Personal Information**

(Print or Type)

To the extent permitted by law, this affidavit will be kept confidential by the state insurance regulatory authority. The affiant may be required to provide additional information during the third-party verification process if they have attended a foreign school or lived and worked internationally.

Full name, address, and telephone number of the present or proposed entity under which this biographical statement is being required (Do Not Use Group Names).

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1. Affiant's Full Name (Initials Not Acceptable): First: \_\_\_\_\_ Middle: \_\_\_\_\_ Last: \_\_\_\_\_  
IF ANSWER IS "NONE," SO STATE.

2. Have you ever used any other name, including first, middle or last name, nickname, maiden name or aliases?

Yes ☐ No ☐

If yes, give the reason if any, if none indicate such, and provide the full name(s) and date(s) used.

<u>Beginning/Ending</u> <u>Date(s) Used (MM/YY)</u>	<u>Name(s)</u> <u>Specify: First, Middle or Last Name</u>	<u>Reason (If none, indicate such)</u>
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

Note: Dates provided in response to this question may be approximate. Parties using this form understand that there could be an overlap of dates when transitioning from one name to another. If applicable, provide the foreign student Identification Number and/or attach foreign diploma or certificate of attendance to the Biographical Affidavit Personal Supplemental Information.

3. Affiant's Social Security Number: \_\_\_\_\_

4. Government Identification Number if not a U.S. Citizen: \_\_\_\_\_

5. Foreign Student ID# (if applicable) : \_\_\_\_\_



Applicant Company Name : \_\_\_\_\_

NAIC No. \_\_\_\_\_

FEIN: \_\_\_\_\_

6. Date of Birth: (MM/DD/YY) : \_\_\_\_\_ Place of Birth, City: \_\_\_\_\_  
State/Province: \_\_\_\_\_ Country: \_\_\_\_\_

7. Name of Affiant's Spouse (if applicable) : \_\_\_\_\_

8. List your residences for the last ten (10) years starting with your current address, giving:

Beginning/Ending Dates (MM/YY)	Address	City	State/ Province	Country	Postal Code
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Note: Dates provided in response to this question may be approximate, except for current address. Parties using this form understand that there could be an overlap of dates when transitioning from one address to another.

Dated and signed this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_ at \_\_\_\_\_. I hereby certify under penalty of perjury that I am acting on my own behalf and that the foregoing statements are true and correct to the best of my knowledge and belief.

\_\_\_\_ I hereby acknowledge that I may be contacted to provide additional information regarding international searches.

\_\_\_\_\_  
(Signature of Affiant)

State of: \_\_\_\_\_ County of: \_\_\_\_\_

The foregoing instrument was acknowledged before me this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_ by \_\_\_\_\_, and:

☐ who is personally known to me, or

☐ who produced the following identification: \_\_\_\_\_

[SEAL]

\_\_\_\_\_  
Notary Public

\_\_\_\_\_  
Printed Notary Name

\_\_\_\_\_  
My Commission Expires

## DISCLOSURE AND AUTHORIZATION CONCERNING BACKGROUND REPORTS

*(All states except California, Minnesota and Oklahoma)*

This Disclosure and Authorization is provided to you in connection with pending or future application(s) of \_\_\_\_\_ [company name] ("Company") for licensure or a permit to organize ("Application") with a department of insurance in one or more states within the United States. Company desires to procure a consumer or investigative consumer report (or both) ("Background Reports") regarding your background for review by a department of insurance in any state where Company pursues an Application during the term of your functioning as, or seeking to function as, an officer, member of the board of directors or other management representative ("Affiant") of Company or of any business entities affiliated with Company ("Term of Affiliation") for which a Background Report is required by a department of insurance reviewing any Application. Background Reports requested pursuant to your authorization below may contain information bearing on your character, general reputation, personal characteristics, mode of living and credit standing. The purpose of such Background Reports will be to evaluate the Application and your background as it pertains thereto. To the extent required by law, the Background Reports procured under this Disclosure and Authorization will be maintained as confidential.

You may obtain copies of any Background Reports about you from the consumer reporting agency ("CRA") that produces them. You may also request more information about the nature and scope of such reports by submitting a written request to Company. To obtain contact information regarding CRA or to submit a written request for more information, contact \_\_\_\_\_ [company's designated person, position, or department, address and phone].

Attached for your information is a "Summary of Your Rights Under the Fair Credit Reporting Act."

**AUTHORIZATION:** I am currently an Affiant of Company as defined above. I have read and understand the above Disclosure and by my signature below, I consent to the release of Background Reports to a department of insurance in any state where Company files or intends to file an Application, and to the Company, for purposes of investigating and reviewing such Application and my status as an Affiant. I authorize all third parties who are asked to provide information concerning me to cooperate fully by providing the requested information to CRA retained by Company for purposes of the foregoing Background Reports, except records that have been erased or expunged in accordance with law.

I understand that I may revoke this Authorization at any time by delivering a written revocation to Company and that Company will, in that event, forward such revocation promptly to any CRA that either prepared or is preparing Background Reports under this Disclosure and Authorization. This Authorization shall remain in full force and effect until the earlier of (i) the expiration of the Term of Affiliation, (ii) written revocation as described above, or (iii) six (6) months following the date of my signature below.

A true copy of this Disclosure and Authorization shall be valid and have the same force and effect as the signed original.

\_\_\_\_\_  
(Printed Full Name and Residence Address)

\_\_\_\_\_  
(Signature)

\_\_\_\_\_  
(Date)

State of: \_\_\_\_\_ County of: \_\_\_\_\_

The foregoing instrument was acknowledged before me this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_ by \_\_\_\_\_, and:

☐ who is personally known to me, or

who produced the following identification: \_\_\_\_\_

[SEAL]

\_\_\_\_\_  
Notary Public

\_\_\_\_\_  
Printed Notary Name

\_\_\_\_\_  
My Commission Expires

Applicant Company Name : \_\_\_\_\_

NAIC No. \_\_\_\_\_

FEIN: \_\_\_\_\_

**DISCLOSURE AND AUTHORIZATION CONCERNING BACKGROUND REPORTS**  
**(Minnesota and Oklahoma)**

This Disclosure and Authorization is provided to you in connection with pending or future application(s) of \_\_\_\_\_ [company name] ("Company") for licensure or a permit to organize ("Application") with a department of insurance in one or more states within the United States. Company desires to procure a consumer or investigative consumer report (or both) ("Background Reports") regarding your background for review by a department of insurance in any state where Company pursues an Application during the term of your functioning as, or seeking to function as, an officer, member of the board of directors or other management representative ("Affiant") of Company or of any business entities affiliated with Company ("Term of Affiliation") for which a Background Report is required by a department of insurance reviewing any Application. Background Reports requested pursuant to your authorization below may contain information bearing on your character, general reputation, personal characteristics, mode of living and credit standing. The purpose of such Background Reports will be to evaluate the Application and your background as it pertains thereto. To the extent required by law, the Background Reports procured under this Disclosure and Authorization will be maintained as confidential.

You may request more information about the nature and scope of Background Reports produced by any consumer reporting agency ("CRA") by submitting a written request to Company. You should submit any such written request for more information, to \_\_\_\_\_ [company's designated person, position, or department, address and phone].

Attached for your information is a "Summary of Your Rights Under the Fair Credit Reporting Act." You will be provided with a copy of any Background Report procured by Company if you check the box below.

- ☐ By checking this box, I request a copy of any Background Report from any CRA retained by Company, at no extra charge.

**AUTHORIZATION:** I am currently an Affiant of Company as defined above. I have read and understand the above Disclosure and by my signature below, I consent to the release of Background Reports to a department of insurance in any state where Company files or intends to file an Application, and to the Company, for purposes of investigating and reviewing such Application and my status as an Affiant. I authorize all third parties who are asked to provide information concerning me to cooperate fully by providing the requested information to CRA retained by Company for purposes of the foregoing Background Reports, except records that have been erased or expunged in accordance with law.

I understand that I may revoke this Authorization at any time by delivering a written revocation to Company and that Company will, in that event, forward such revocation promptly to any CRA that either prepared or is preparing Background Reports under this Disclosure and Authorization. This Authorization shall remain in full force and effect until the earlier of (i) the expiration of the Term of Affiliation, (ii) written revocation as described above, or (iii) six (6) months following the date of my signature below.

A true copy of this Disclosure and Authorization shall be valid and have the same force and effect as the signed original.

\_\_\_\_\_  
(Printed Full Name and Residence Address)

\_\_\_\_\_  
(Signature)

\_\_\_\_\_  
(Date)

State of: \_\_\_\_\_ County of: \_\_\_\_\_

The foregoing instrument was acknowledged before me this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_ by \_\_\_\_\_, and:

- ☐ who is personally known to me, or

who produced the following identification: \_\_\_\_\_

[SEAL]

\_\_\_\_\_  
Notary Public

\_\_\_\_\_  
Printed Notary Name

\_\_\_\_\_  
My Commission Expires

**DISCLOSURE AND AUTHORIZATION CONCERNING BACKGROUND REPORTS**  
**(California)**

This Disclosure and Authorization is provided to you in connection with a pending application of \_\_\_\_\_ [company name] ("Company") for licensure or a permit to organize ("Application") with a department of insurance in one or more states within the United States. Company desires to procure a consumer or investigative consumer report (or both) ("Background Reports") regarding your background for review by any department of insurance in such states where Company is currently pursuing an Application, because you are either functioning as, or are seeking to function as, an officer, member of the board of directors or other management representative ("Affiant") of Company or of any business entities affiliated with Company ("Term of Affiliation") for which a Background Report is required by a department of insurance reviewing any Application. Background Reports will be obtained through \_\_\_\_\_ [name of CRA, address] ("CRA"). Background Reports requested pursuant to your authorization below may contain information bearing on your character, general reputation, personal characteristics, mode of living and credit standing. The purpose of such Background Reports will be to evaluate the Application and your background as it pertains thereto. To the extent required by law, the Background Reports procured under this Disclosure and Authorization will be maintained as confidential.

You may request more information about the nature and scope of Background Reports produced by any consumer reporting agency ("CRA") by submitting a written request to Company. You should submit any such written request for more information, to \_\_\_\_\_ [company's designated person, position, or department, address and phone].

Attached for your information is a "Summary of Your Rights Under the Fair Credit Reporting Act." You will be provided with a copy of any Background Report procured by Company if you check the box below.

- ☐ By checking this box, I request a copy of any Background Report from any CRA retained by Company, at no extra charge.

Under section 1786.22 of the California Civil Code, you may view the file maintained on you by the CRA listed above. You may also obtain a copy of this file, upon submitting proper identification and paying the costs of duplication services, by appearing at the CRA in person or by mail; you may also receive a summary of the file by telephone. The CRA is required to have personnel available to explain your file to you and the CRA must explain to you any coded information appearing in your file. If you appear in person, you may be accompanied by one other person of your choosing, provided that person furnishes proper identification.

**AUTHORIZATION:** I am currently an Affiant of Company as defined above. I have read and understand the above Disclosure and by my signature below, I consent to the release of Background Reports to a department of insurance in any state where Company files or intends to file an Application, and to the Company, for purposes of investigating and reviewing such Application and my status as an Affiant. I authorize all third parties who are asked to provide information concerning me to cooperate fully by providing the requested information to CRA retained by Company for purposes of the foregoing Background Reports, except records that have been erased or expunged in accordance with law.

I understand that I may revoke this Authorization at any time by delivering a written revocation to Company and that Company will, in that event, forward such revocation promptly to any CRA that either prepared or is preparing Background Reports under this Disclosure and Authorization. In no event, however, will this authorization remain in effect beyond six (6) months following the date of my signature below.

A true copy of this Disclosure and Authorization shall be valid and have the same force and effect as the signed original.

\_\_\_\_\_  
(Printed Full Name and Residence Address)

\_\_\_\_\_  
(Signature)

\_\_\_\_\_  
(Date)

State of: \_\_\_\_\_ County of: \_\_\_\_\_

The foregoing instrument was acknowledged before me this \_\_\_\_ day of \_\_\_\_\_, 20 by \_\_\_\_\_, and:

- ☐ who is personally known to me, or  
☐ who produced the following identification: \_\_\_\_\_

[SEAL]

\_\_\_\_\_  
Notary Public

\_\_\_\_\_  
Printed Notary Name

\_\_\_\_\_  
My Commission Expires

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M E M O R A N D U M

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**DATE:** November 15, 2018  
**TO:** David Altmaier, Commissioner, Office of Insurance Regulation  
**THROUGH:** Anoush Brangaccio, General Counsel  
**FROM:** Michael Lawrence, Jr., Assistant General Counsel  
**SUBJECT:** Cabinet Agenda for December 4, 2018  
Request for Approval to Publish New Rule  
Rules 69O-238.001,.002  
Assignment # 224829-18

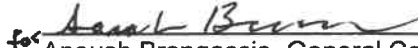
The Office of Insurance Regulation requests that these proposed new rules be presented to the Cabinet aides on or before November 28, 2018, and to the Financial Services Commission on December 4, 2018, with a request to approve for publication the proposed rules.

Chapter 69O-238, F.A.C., will govern the regulation of Pharmacy Benefit Managers.

Sections 624.490(2); 624.490(6); 624.490, F.S., are the rulemaking authority and laws implemented for these rules.

Michael Lawrence, Jr., is the attorney handling these rules. Attached are: 1) the proposed rule(s), 2) any incorporated materials, such as forms; and 3) copies of the rulemaking statutory authority and law implemented.

Approved for signature:

  
for Anoush Brangaccio, General Counsel

Approved for submission to Financial Services  
Commission:

  
David Altmaier, Commissioner  
Office of Insurance Regulation

**CHAPTER 690-238**  
**PHARMACY BENEFIT MANAGERS**

690-238.001     Application and Renewal

690-238.002     Change in Information

690-238.001 Application and Renewal.

(1) An applicant for initial registration as a pharmacy benefit manager shall submit the following:

(a) A nonrefundable fee of \$5.00 made payable to the Florida Department of Financial Services along with a completed Form OIR-C1-2210, Registration Form for Pharmacy Benefit Managers Invoice, effective 01/19, hereby incorporated by reference and available at [www.flrules.org/XXXXX](http://www.flrules.org/XXXXX). The applicant shall submit the nonrefundable fee and Form OIR-C1-2210 to the Department of Financial Services, Bureau of Financial Services, P. O. Box 6100, Tallahassee, Florida 32314-1600;

(b) A copy of the applicant's corporate charter, articles of incorporation, or other charter document submitted electronically via the Office's iApply system at <https://www.flair.com/iportal>; and

(c) A completed Form OIR-C1-2209, Registration Form for Pharmacy Benefit Managers, effective 01/19, hereby incorporated by reference and available at [www.flrules.org/XXXXX](http://www.flrules.org/XXXXX), submitted electronically via the Office's iApply system at <https://www.flair.com/iportal>.

(2) Each registrant renewing its registration shall submit a nonrefundable fee of \$5.00 made payable to the Florida Department of Financial Services along with a completed Form OIR-C1-2210 to the Department of Financial Services, Bureau of Financial Services, P. O. Box 6100, Tallahassee, Florida 32314-1600.

Rulemaking Authority 624.490(2), 627.490(6) FS. Law Implemented 624.490 FS. History— History-New \_\_\_\_\_.

690-238.002 Change in Information.

Pursuant section 624.490(3), F.S., if the information required by section 624.490(2), F.S., changes, the registrant shall file an amendment on the Form OIR-C1-2209, Registration Form for Pharmacy Benefit Managers, effective 01/19, hereby incorporated by reference and available at [www.flrules.org/XXXXX](http://www.flrules.org/XXXXX), submitted electronically via the Office's iApply system at <https://www.flair.com/iportal> within 60 days after the change occurs.

Rulemaking Authority 624.490(3); 627.490(6). Law Implemented 624.490 FS. History— History-New \_\_\_\_\_.

**624.490 Registration of pharmacy benefit managers.—**

- (1) As used in this section, the term “pharmacy benefit manager” means a person or entity doing business in this state which contracts to administer prescription drug benefits on behalf of a health insurer or a health maintenance organization to residents of this state.
  - (2) Effective January 1, 2019, to conduct business in this state, a pharmacy benefit manager must register with the office. To initially register or renew a registration, a pharmacy benefit manager shall submit:
    - (a) A nonrefundable fee not to exceed \$500.
    - (b) A copy of the registrant’s corporate charter, articles of incorporation, or other charter document.
    - (c) A completed registration form adopted by the commission containing:
      1. The name and address of the registrant.
      2. The name, address, and official position of each officer and director of the registrant.
    - (3) The registrant shall report any change in information required by subsection (2) to the office in writing within 60 days after the change occurs.
    - (4) Upon receipt of a completed registration form, the required documents, and the registration fee, the office shall issue a registration certificate. The certificate may be in paper or electronic form and shall clearly indicate the expiration date of the registration. Registration certificates are nontransferable.
    - (5) A registration certificate is valid for 2 years after its date of issue. The commission shall adopt by rule an initial registration fee not to exceed \$500 and a registration renewal fee not to exceed \$500, both of which shall be nonrefundable. Total fees may not exceed the cost of administering this section.
    - (6) The commission shall adopt rules necessary to implement this section.
- History.—**s. 3, ch. 2018-91.

**Part VI: Health Insurance Policies**

**627.64741 Pharmacy benefit manager contracts.—**

- (1) As used in this section, the term:
  - (a) “Maximum allowable cost” means the per-unit amount that a pharmacy benefit manager reimburses a pharmacist for a prescription drug, excluding dispensing fees, prior to the application of copayments, coinsurance, and other cost-sharing charges, if any.
  - (b) “Pharmacy benefit manager” means a person or entity doing business in this state which contracts to administer or manage prescription drug benefits on behalf of a health insurer to residents of this state.
- (2) A contract between a **health insurer** and a pharmacy benefit manager **must require** that the pharmacy benefit manager:
  - (a) Update maximum allowable cost pricing information at least every 7 calendar days.
  - (b) Maintain a process that will, in a timely manner, eliminate drugs from maximum allowable cost lists or modify drug prices to remain consistent with changes in pricing data used in formulating maximum allowable cost prices and product availability.
- (3) A contract between a health insurer and a pharmacy benefit manager **must prohibit** the pharmacy benefit manager from limiting a pharmacist’s ability to disclose whether the cost-sharing obligation exceeds the retail price for a covered prescription drug, and the availability of a more affordable alternative drug, pursuant to s. 465.0244.

(4) A contract between a health insurer and a pharmacy benefit manager must prohibit the pharmacy benefit manager from requiring an insured to make a payment for a prescription drug at the point of sale in an amount that exceeds the lesser of:

(a) The applicable cost-sharing amount; or

(b) The retail price of the drug in the absence of prescription drug coverage.

(5) This section applies to contracts entered into or renewed on or after July 1, 2018.

**History.**—s. 4, ch. 2018-91.

## **Part VII: Group Life Insurance Policies**

### **627.6572 Pharmacy benefit manager contracts.—**

(1) As used in this section, the term:

(a) “Maximum allowable cost” means the per-unit amount that a pharmacy benefit manager reimburses a pharmacist for a prescription drug, excluding dispensing fees, prior to the application of copayments, coinsurance, and other cost-sharing charges, if any.

(b) “Pharmacy benefit manager” means a person or entity doing business in this state which contracts to administer or manage prescription drug benefits on behalf of a health insurer to residents of this state.

(2) A contract between a **health insurer** and a pharmacy benefit manager must require that the pharmacy benefit manager:

(a) Update maximum allowable cost pricing information at least every 7 calendar days.

(b) Maintain a process that will, in a timely manner, eliminate drugs from maximum allowable cost lists or modify drug prices to remain consistent with changes in pricing data used in formulating maximum allowable cost prices and product availability.

(3) A contract between a health insurer and a pharmacy benefit manager must prohibit the pharmacy benefit manager from limiting a pharmacist’s ability to disclose whether the cost-sharing obligation exceeds the retail price for a covered prescription drug, and the availability of a more affordable alternative drug, pursuant to s. 465.0244.

(4) A contract between a health insurer and a pharmacy benefit manager must prohibit the pharmacy benefit manager from requiring an insured to make a payment for a prescription drug at the point of sale in an amount that exceeds the lesser of:

(a) The applicable cost-sharing amount; or

(b) The retail price of the drug in the absence of prescription drug coverage.

(5) This section applies to contracts entered into or renewed on or after July 1, 2018.

**History.**—s. 5, ch. 2018-91.

## **Part I: Health Maintenance Organizations**

### **641.314 Pharmacy benefit manager contracts.—**

(1) As used in this section, the term:

(a) “Maximum allowable cost” means the per-unit amount that a pharmacy benefit manager reimburses a pharmacist for a prescription drug, excluding dispensing fees, prior to the application of copayments, coinsurance, and other cost-sharing charges, if any.

(b) “Pharmacy benefit manager” means a person or entity doing business in this state which contracts to administer or manage prescription drug benefits on behalf of a health maintenance organization to residents of this state.

(2) A contract between a **health maintenance organization** and a pharmacy benefit manager must require that the pharmacy benefit manager:



- (a) Update maximum allowable cost pricing information at least every 7 calendar days.
- (b) Maintain a process that will, in a timely manner, eliminate drugs from maximum allowable cost lists or modify drug prices to remain consistent with changes in pricing data used in formulating maximum allowable cost prices and product availability.
- (3) A contract between a health maintenance organization and a pharmacy benefit manager must prohibit the pharmacy benefit manager from limiting a pharmacist's ability to disclose whether the cost-sharing obligation exceeds the retail price for a covered prescription drug, and the availability of a more affordable alternative drug, pursuant to s. 465.0244.
- (4) A contract between a health maintenance organization and a pharmacy benefit manager must prohibit the pharmacy benefit manager from requiring a subscriber to make a payment for a prescription drug at the point of sale in an amount that exceeds the lesser of:
  - (a) The applicable cost-sharing amount; or
  - (b) The retail price of the drug in the absence of prescription drug coverage.
- (5) This section applies to contracts entered into or renewed on or after July 1, 2018.

**History.**—s. 6, ch. 2018-91.

**624.310 Enforcement; cease and desist orders; removal of certain persons; fines.—**

(1) **DEFINITIONS.**—For the purposes of this section, the term:

(a) “Affiliated party” means any person who directs or participates in the conduct of the affairs of a licensee and who is:

- 1. A director, officer, employee, trustee, committee member, or controlling stockholder of a licensee or a subsidiary or service corporation of the licensee, other than a controlling stockholder which is a holding company, or an agent of a licensee or a subsidiary or service corporation of the licensee;
- 2. A person who has filed or is required to file a statement or any other information required to be filed under s. 628.461 or s. 628.4615;
- 3. A stockholder, other than a stockholder that is a holding company of the licensee, who participates in the conduct of the affairs of the licensee;
- 4. An independent contractor who:
  - a. Renders a written opinion required by the laws of this state under her or his professional credentials on behalf of the licensee, which opinion is reasonably relied on by the department or office in the performance of its duties; or
  - b. Affirmatively and knowingly conceals facts, through a written misrepresentation to the department or office, with knowledge that such misrepresentation:
    - (I) Constitutes a violation of the insurance code or a lawful rule or order of the department, commission, or office; and
    - (II) Directly and materially endangers the ability of the licensee to meet its obligations to policyholders.

For the purposes of this subparagraph, any representation of fact made by an independent contractor on behalf of a licensee, affirmatively communicated as a representation of the licensee to the independent contractor, shall not be considered a misrepresentation by the independent contractor; or

5. A third-party marketer who aids or abets a licensee in a violation of the insurance code relating to the sale of an annuity to a person 65 years of age or older.

(b) “Licensee” means a person issued a license or certificate of authority or approval under this code or a person registered under a provision of this code.

(2) ENFORCEMENT GENERALLY.—

(a) The powers granted by this section to the office apply only with respect to licensees of the office and their affiliated parties and to unlicensed persons subject to the regulatory jurisdiction of the office, and the powers granted by this section to the department apply only with respect to licensees of the department and their affiliated parties and to unlicensed persons subject to regulatory jurisdiction of the department.

(b) The department and office each may institute such suits or other legal proceedings as may be required to enforce any provision of this code within the respective regulatory jurisdiction of each. If it appears that any person has violated any provision of this code for which criminal prosecution is provided, the department or office shall provide the appropriate state attorney or other prosecuting agency having jurisdiction with respect to such prosecution with the relevant information in its possession.

(3) CEASE AND DESIST ORDERS.—

(a) The department or office may issue and serve a complaint stating charges upon any licensee or upon any affiliated party, whenever the department or office has reasonable cause to believe that the person or individual named therein is engaging in or has engaged in conduct that is:

1. An act that demonstrates a lack of fitness or trustworthiness to engage in the business of insurance, is hazardous to the insurance buying public, or constitutes business operations that are a detriment to policyholders, stockholders, investors, creditors, or the public;
2. A violation of any provision of the Florida Insurance Code;
3. A violation of any rule of the department or commission;
4. A violation of any order of the department or office; or
5. A breach of any written agreement with the department or office.

(b) The complaint shall contain a statement of facts and notice of opportunity for a hearing pursuant to ss. 120.569 and 120.57.

(c) If no hearing is requested within the time allowed by ss. 120.569 and 120.57, or if a hearing is held and the department or office finds that any of the charges are proven, the department or office may enter an order directing the licensee or the affiliated party named in the complaint to cease and desist from engaging in the conduct complained of and take corrective action to remedy the effects of past improper conduct and assure future compliance.

(d) If the licensee or affiliated party named in the order fails to respond to the complaint within the time allotted by ss. 120.569 and 120.57, the failure constitutes a default and justifies the entry of a cease and desist order.

(e) A contested or default cease and desist order is effective when reduced to writing and served upon the licensee or affiliated party named therein. An uncontested cease and desist order is effective as agreed.

(f) Whenever the department or office finds that conduct described in paragraph (a) is likely to cause insolvency, substantial dissipation or misvaluation of assets or earnings of the licensee, substantial inability to pay claims on a timely basis, or substantial prejudice to prospective or existing insureds, policyholders, subscribers, or the public, it may issue an emergency cease and desist order requiring the licensee or any affiliated party to immediately cease and desist from engaging in the conduct complained of and to take corrective and remedial action. The emergency order is effective immediately upon service of a copy of the order upon the licensee or affiliated party named therein and remains effective for 90 days. If the department or office begins nonemergency cease and desist proceedings under this subsection, the emergency order remains effective until the conclusion of the proceedings under ss. 120.569 and 120.57. Any

emergency order entered under this subsection is exempt from s. 119.07(1) and is confidential until it is made permanent unless the department or office finds that the confidentiality will result in substantial risk of financial loss to the public. All emergency cease and desist orders that are not made permanent are available for public inspection 1 year from the date the emergency cease and desist order expires; however, portions of an emergency cease and desist order remain confidential and exempt from the provisions of s. 119.07(1) if disclosure would:

1. Jeopardize the integrity of another active investigation;
2. Impair the safety and financial soundness of the licensee or affiliated party;
3. Reveal personal financial information;
4. Reveal the identity of a confidential source;
5. Defame or cause unwarranted damage to the good name or reputation of an individual or jeopardize the safety of an individual; or
6. Reveal investigative techniques or procedures.

(4) REMOVAL OF AFFILIATED PARTIES.—

(a) The department or office may issue and serve a complaint stating charges upon any affiliated party and upon the licensee involved, whenever the department or office has reason to believe that an affiliated party is engaging in or has engaged in conduct that constitutes:

1. An act that demonstrates a lack of fitness or trustworthiness to engage in the business of insurance through engaging in illegal activity or mismanagement of business activities;
2. A willful violation of any law relating to the business of insurance; however, if the violation constitutes a misdemeanor, no complaint shall be served as provided in this section until the affiliated party is notified in writing of the matter of the violation and has been afforded a reasonable period of time, as set forth in the notice, to correct the violation and has failed to do so;
3. A violation of any other law involving fraud or moral turpitude that constitutes a felony;
4. A willful violation of any rule of the department or commission;
5. A willful violation of any order of the department or office;
6. A material misrepresentation of fact, made knowingly and willfully or made with reckless disregard for the truth of the matter; or
7. An act of commission or omission or a practice which is a breach of trust or a breach of fiduciary duty.

(b) The complaint shall contain a statement of facts and notice of opportunity for a hearing pursuant to ss. 120.569 and 120.57.

(c) If no hearing is requested within the time allotted by ss. 120.569 and 120.57, or if a hearing is held and the department or office finds that any of the charges in the complaint are proven true and that:

1. The licensee has suffered or will likely suffer loss or other damage;
2. The interests of the policyholders, creditors, or public are, or could be, seriously prejudiced by reason of the violation or act or breach of fiduciary duty;
3. The affiliated party has received financial gain by reason of the violation, act, or breach of fiduciary duty; or
4. The violation, act, or breach of fiduciary duty is one involving personal dishonesty on the part of the affiliated party or the conduct jeopardizes or could reasonably be anticipated to jeopardize the financial soundness of the licensee,

The department or office may enter an order removing the affiliated party or restricting or prohibiting participation by the person in the affairs of that particular licensee or of any other licensee.

(d) If the affiliated party fails to respond to the complaint within the time allotted by ss. 120.569 and 120.57, the failure constitutes a default and justifies the entry of an order of removal, suspension, or restriction.

(e) A contested or default order of removal, restriction, or prohibition is effective when reduced to writing and served on the licensee and the affiliated party. An uncontested order of removal, restriction, or prohibition is effective as agreed.

(f)1. The chief executive officer, or the person holding the equivalent office, of a licensee shall promptly notify the department or office that issued the license if she or he has actual knowledge that any affiliated party is charged with a felony in a state or federal court.

2. Whenever any affiliated party is charged with a felony in a state or federal court or with the equivalent of a felony in the courts of any foreign country with which the United States maintains diplomatic relations, and the charge alleges violation of any law involving fraud, theft, or moral turpitude, the department or office may enter an emergency order suspending the affiliated party or restricting or prohibiting participation by the affiliated party in the affairs of the particular licensee or of any other licensee upon service of the order upon the licensee and the affiliated party charged. The order shall contain notice of opportunity for a hearing pursuant to ss. 120.569 and 120.57, where the affiliated party may request a postsuspension hearing to show that continued service to or participation in the affairs of the licensee does not pose a threat to the interests of the licensee's policyholders or creditors and does not threaten to impair public confidence in the licensee. In accordance with applicable rules, the department or office shall notify the affiliated party whether the order suspending or prohibiting the person from participation in the affairs of a licensee will be rescinded or otherwise modified. The emergency order remains in effect, unless otherwise modified by the department or office, until the criminal charge is disposed of. The acquittal of the person charged, or the final, unappealed dismissal of all charges against the person, dissolves the emergency order, but does not prohibit the department or office from instituting proceedings under paragraph (a). If the person charged is convicted or pleads guilty or nolo contendere, whether or not an adjudication of guilt is entered by the court, the emergency order shall become final.

(g) Any affiliated party removed from office pursuant to this section is not eligible for reelection or appointment to the position or to any other official position in any licensee in this state except upon the written consent of the department or office. Any affiliated party who is removed, restricted, or prohibited from participation in the affairs of a licensee pursuant to this section may petition the department or office for modification or termination of the removal, restriction, or prohibition.

(h) Resignation or termination of an affiliated party does not affect the department's or office's jurisdiction to proceed under this subsection.

#### (5) ADMINISTRATIVE FINES; ENFORCEMENT.—

(a) The department or office may, in a proceeding initiated pursuant to chapter 120, impose an administrative fine against any person found in the proceeding to have violated any provision of this code, a cease and desist order of the department or office, or any written agreement with the department or office. No proceeding shall be initiated and no fine shall accrue until after the person has been notified in writing of the nature of the violation and has been afforded a

reasonable period of time, as set forth in the notice, to correct the violation and has failed to do so.

(b) A fine imposed under this subsection may not exceed the amounts specified in s. 624.4211, per violation.

(c) The department or office may, in addition to the imposition of an administrative fine under this subsection, also suspend or revoke the license or certificate of authority of the licensee fined under this subsection.

(d) Any administrative fine levied by the department or office under this subsection may be enforced by the department or office by appropriate proceedings in the circuit court of the county in which the person resides or in which the principal office of a licensee is located, or, in the case of a foreign insurer or person not residing in this state, in Leon County. In any administrative or judicial proceeding arising under this section, a party may elect to correct the violation asserted by the department or office, and, upon doing so, any fine shall cease to accrue; however, the election to correct the violation does not render any administrative or judicial proceeding moot. All fines collected under this section shall be paid to the Insurance Regulatory Trust Fund.

(e) In imposing any administrative penalty or remedy provided for under this section, the department or office shall take into account the appropriateness of the penalty with respect to the size of the financial resources and the good faith of the person charged, the gravity of the violation, the history of previous violations, and other matters as justice may require.

(f) The imposition of an administrative fine under this subsection may be in addition to any other penalty or administrative fine authorized under this code.

(6) ADMINISTRATIVE PROCEDURES.—All administrative proceedings under subsections (3), (4), and (5) shall be conducted in accordance with chapter 120. Any service required or authorized to be made by the department or office under this code shall be made:

(a)1. By certified mail, return receipt requested, delivered to the addressee only; or

2. If service by certified mail cannot be obtained at the last address provided to the department by the recipient, then by e-mail, delivery receipt required, sent to the most recent e-mail address provided to the department by the applicant or licensee in accordance with s. 626.171, s. 626.551, s. 648.34, or s. 648.421;

(b) By personal delivery, including hand delivery by a department investigator;

(c) By publication in accordance with s. 120.60; or

(d) In accordance with chapter 48.

The service provided for in this subsection shall be effective from the date of delivery.

(7) OTHER LAWS NOT SUPERSEDED.—The provisions of this section are in addition to other provisions of this code, and shall not be construed to curtail, impede, replace, or delete any other similar provision or power of the department or office under the insurance code as defined in s. 624.01 or any power of the department or office which may exist under the common law of this state. The procedures set forth in s. 626.9581 do not apply to regulatory action taken pursuant to the provisions of this section.

(8) CRIMINAL ENFORCEMENT.—It is unlawful for any affiliated party who is removed or prohibited from participation in the affairs of a licensee pursuant to this section, or for any licensee whose rights or privileges under such license have been suspended or revoked pursuant to the Florida Insurance Code, to knowingly act as an affiliated party as defined in this section or to knowingly transact insurance as defined in s. 624.10 until expressly authorized to do so by the department or office. Such authorization by the department or office may not be provided unless the affiliated party or the licensee has made restitution, if applicable, to all parties damaged by

the actions of the affiliated party or the licensee which served as the basis for the removal or prohibition of the affiliated party or the suspension or revocation of the rights and privileges of the licensee. Any person who violates the provisions of this subsection commits a felony of the third degree, punishable as provided in s. 775.082, s. 775.083 or s. 775.084.

**History.**—s. 25, ch. 59-205; ss. 13, 35, ch. 69-106; s. 26, ch. 73-334; s. 3, ch. 76-168; s. 1, ch. 77-457; ss. 2, 3, ch. 81-318; ss. 22, 37, 809(1st), ch. 82-243; ss. 5, 187, 188, ch. 91-108; s. 4, ch. 91-429; s. 1, ch. 93-78; s. 9, ch. 95-211; s. 363, ch. 96-406; s. 267, ch. 96-410; s. 1719, ch. 97-102; s. 3, ch. 2003-148; s. 763, ch. 2003-261; s. 42, ch. 2010-175; s. 44, ch. 2011-4; s. 2, ch. 2014-123.

**624.307 General powers; duties.—**

(1) The department and office shall enforce the provisions of this code and shall execute the duties imposed upon them by this code, within the respective jurisdiction of each, as provided by law.

(2) The department shall have the powers and authority expressly conferred upon it by, or reasonably implied from, the provisions of this code. The office shall have the powers and authority expressly conferred upon it by, or reasonably implied from, the provisions of this code.

(3) The department or office may conduct such investigations of insurance matters, in addition to investigations expressly authorized, as it may deem proper to determine whether any person has violated any provision of this code within its respective regulatory jurisdiction or to secure information useful in the lawful administration of any such provision. The cost of such investigations shall be borne by the state.

(4) The department and office may each collect, propose, publish, and disseminate information relating to the subject matter of any duties imposed upon it by law.

(5) The department and office shall each have such additional powers and duties as may be provided by other laws of this state.

(6) The department and office may each employ actuaries who shall be at-will employees and who shall serve at the pleasure of the Chief Financial Officer, in the case of department employees, or at the pleasure of the director of the office, in the case of office employees. Actuaries employed pursuant to this paragraph shall be members of the Society of Actuaries or the Casualty Actuarial Society and shall be exempt from the Career Service System established under chapter 110. The salaries of the actuaries employed pursuant to this paragraph shall be set in accordance with <sup>1</sup>s. 216.251(2)(a)5. and shall be set at levels which are commensurate with salary levels paid to actuaries by the insurance industry.

(7) The department and office, within existing resources, may expend funds for the professional development of their employees, including, but not limited to, professional dues for employees who are required to be members of professional organizations; examinations leading to professional designations required for employment with the office; training courses and examinations provided through, and to ensure compliance with, the National Association of Insurance Commissioners; or other training courses related to the regulation of insurance.

(8) The office shall, within existing resources, develop and implement an outreach program for the purpose of encouraging the entry of additional insurers into the Florida market.

(9) Upon receiving service of legal process issued in any civil action or proceeding in this state against any regulated person or any unauthorized insurer under s. 626.906 or s. 626.937 which is required to appoint the Chief Financial Officer as its attorney to receive service of all legal process, the Chief Financial Officer, as attorney, may, in lieu of sending the process by

registered or certified mail, send the process or make it available by any other verifiable means, including, but not limited to, making the documents available by electronic transmission from a secure website established by the department to the person last designated by the regulated person or the unauthorized insurer to receive the process. When process documents are made available electronically, the Chief Financial Officer shall send a notice of receipt of service of process to the person last designated by the regulated person or unauthorized insurer to receive legal process. The notice must state the date and manner in which the copy of the process was made available to the regulated person or unauthorized insurer being served and contain the uniform resource locator (URL) for a hyperlink to access files and information on the department's website to obtain a copy of the process.

(10)(a) The Division of Consumer Services shall perform the following functions concerning products or services regulated by the department or office:

1. Receive inquiries and complaints from consumers.
2. Prepare and disseminate information that the department deems appropriate to inform or assist consumers.
3. Provide direct assistance to and advocacy for consumers who request such assistance or advocacy.
4. With respect to apparent or potential violations of law or applicable rules committed by a person or entity licensed by the department or office, report apparent or potential violations to the office or to the appropriate division of the department, which may take any additional action it deems appropriate.
5. Designate an employee of the division as the primary contact for consumers on issues relating to sinkholes.

(b) Any person licensed or issued a certificate of authority by the department or the office shall respond, in writing, to the division within 20 days after receipt of a written request for information from the division concerning a consumer complaint. The response must address the issues and allegations raised in the complaint. The division may impose an administrative penalty for failure to comply with this paragraph of up to \$2,500 per violation upon any entity licensed by the department or the office and \$250 for the first violation, \$500 for the second violation, and up to \$1,000 for the third or subsequent violation upon any individual licensed by the department or the office.

(c) The department may adopt rules to administer this subsection.

(d) The powers, duties, and responsibilities expressed or granted in this subsection do not limit the powers, duties, and responsibilities of the department, the Financial Services Commission, the Office of Insurance Regulation, or the Office of Financial Regulation as otherwise provided by law.

**History.**—s. 22, ch. 59-205; ss. 13, 35, ch. 69-106; s. 3, ch. 76-168; s. 1, ch. 77-457; ss. 2, 3, ch. 81-318; ss. 20, 37, 809(1st), ch. 82-243; s. 5, ch. 86-160; ss. 187, 188, ch. 91-108; s. 4, ch. 91-429; s. 1, ch. 93-410; s. 761, ch. 2003-261; s. 101, ch. 2004-5; s. 6, ch. 2004-273; s. 6, ch. 2012-213; s. 10, ch. 2016-132; s. 5, ch. 2016-165; s. 18, ch. 2017-175.

**<sup>1</sup>Note.**—Section 216.251(2)(a)5. was transferred to s. 216.251(2)(a)6. by s. 67, ch. 92-142, and subsequently repealed by s. 36, ch. 2005-152.

**624.317 Investigation of agents, adjusters, administrators, service companies, and others.**—If it has reason to believe that any person has violated or is violating any provision of this code, or upon the written complaint signed by any interested person indicating that any such violation may exist:

(1) The department shall conduct such investigation as it deems necessary of the accounts, records, documents, and transactions pertaining to or affecting the insurance affairs of any agent, adjuster, insurance agency, customer representative, service representative, or other person subject to its jurisdiction, subject to the requirements of s. 626.601.

(2) The office shall conduct such investigation as it deems necessary of the accounts, records, documents, and transactions pertaining to or affecting the insurance affairs of any:

(a) Administrator, service company, or other person subject to its jurisdiction.

(b) Person having a contract or power of attorney under which she or he enjoys in fact the exclusive or dominant right to manage or control an insurer.

(c) Person engaged in or proposing to be engaged in the promotion or formation of:

1. A domestic insurer;

2. An insurance holding corporation; or

3. A corporation to finance a domestic insurer or in the production of the domestic insurer's business.

**History.**—s. 32, ch. 59-205; ss. 13, 35, ch. 69-106; s. 1, ch. 70-55; s. 3, ch. 76-168; s. 1, ch. 77-457; ss. 2, 3, ch. 81-318; ss. 27, 37, 809(1st), ch. 82-243; s. 1, ch. 83-203; ss. 10, 187, 188, ch. 91-108; s. 4, ch. 91-429; s. 179, ch. 97-102; s. 72, ch. 2003-1; s. 772, ch. 2003-261; s. 14, ch. 2003-267; s. 7, ch. 2003-281; s. 16, ch. 2004-390; s. 1, ch. 2005-257; s. 9, ch. 2018-102.





**Office of Insurance Regulation**  
**Company Admissions**

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## **REGISTRATION FORM FOR PHARMACY BENEFIT MANAGERS**

This package is designed to assist individuals in preparing the registration form with all the information required by statute and to facilitate expeditious processing of the registration by this Office.

The completed registration package must be submitted to the Office by utilizing the following link, unless otherwise specified herein:

**<http://www.floir.com/iportal>**  
and select iApply – Online Company Admissions

Any questions concerning this application package may be directed to the Application Coordinator at [appcoord@floir.com](mailto:appcoord@floir.com). For iApply only questions, contact the Application Coordinator at [iapply@floir.com](mailto:iapply@floir.com)

**In order for a submission to be considered a complete registration request, all required information must be included in the filing. Filings that do not include all required information will be disapproved or returned.**

**[Remainder of this page intentionally left blank]**

Form OIR-C1-2209

Effective 01/19

Incorporated by Reference in Rules 69O-238.001 and 69O-238.002, F.A.C.

## REGISTRATION FORM FOR PHARMACY BENEFIT MANAGERS

<b>Name, address, and telephone number of individual to be contacted regarding this registration form:</b>	
Name:	
Address:	
Telephone:	
E-Mail:	

### SECTION A – Name and Address of the Registrant

<b>Name of Proposed Pharmacy Benefit Manager:</b>	
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<b>Address of the Proposed Pharmacy Benefit Manager:</b>	
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**[Remainder of this page intentionally left blank]**

Form OIR-C1-2209

Effective 01/19

Incorporated by Reference in Rules 69O-238.001 and 69O-238.002, F.A.C.

## REGISTRATION FORM FOR PHARMACY BENEFIT MANAGERS

### SECTION B – Name, Address, and Official Position of Each Officer and Director

Name:	
Address:	
Official Position:	
Name:	
Address:	
Official Position:	
Name:	
Address:	
Official Position:	
Name:	
Address:	
Official Position:	
Name:	
Address:	
Official Position:	
Name:	
Address:	
Official Position:	
Name:	
Address:	
Official Position:	
Name:	
Address:	
Official Position:	

Form OIR-C1-2209

Effective 01/19

Incorporated by Reference in Rules 69O-238.001 and 69O-238.002, F.A.C.

Name:	
Address:	
Official Position:	
Name:	
Address:	
Official Position:	
Name:	
Address:	
Official Position:	
Name:	
Address:	
Official Position:	
Name:	
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Official Position:	
Name:	
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Official Position:	
Name:	
Address:	
Official Position:	
Name:	
Address:	
Official Position:	

**[Attach additional page if necessary]**

Form OIR-C1-2209

Effective 01/19

Incorporated by Reference in Rules 69O-238.001 and 69O-238.002, F.A.C.

## REGISTRATION FOR PHARMACY BENEFIT MANAGERS

### INVOICE

Registration is hereby requested as a Pharmacy Benefit Manager in accordance with the Insurance Laws of Florida.

Send the original check made payable to the Florida Department of Financial Services, and mail the check and invoice to the Department of Financial Services, Bureau of Financial Services, P. O. Box 6100, Tallahassee, Florida 32314-1600.

Attach a photocopy of the invoice and check for the amount of the required filing fee for the application being file. If sent electronically, redact the bank account number from the copy of the check for security purposes.

1. Name of Proposed Pharmacy Benefit Manager

\_\_\_\_\_

2. Address\_\_\_\_\_

3. Federal Employer's I.D. No. \_\_\_\_\_

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#### Accounting Information

<u>B/T</u>	<u>F/T</u>	<u>T/C</u>	<u>AMOUNT</u>
XX	XX	XX	\$XXX.00

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**M E M O R A N D U M**

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**DATE:** November 15, 2018  
**TO:** David Altmaier, Commissioner, Office of Insurance Regulation  
**THROUGH:** Anoush Brangaccio, General Counsel  
**FROM:** Michael Lawrence, Jr., Assistant General Counsel  
**SUBJECT:** Cabinet Agenda for December 4, 2018  
Request for Approval to Publish Amendments to  
Rule 69O-137.001  
Assignment # 227525-18


The Office of Insurance Regulation requests that these proposed rule amendments be presented to the Cabinet aides on or before November 28, 2018, and to the Financial Services Commission on December 4, 2018, with a request to approve for publication the proposed rules.

These rules are being amended to adopt the 2018 National Association of Insurance Commissioners electronic transmission filing instructions, 2017 and 2018 NAIC's Annual Statement Instructions, the 2017 and 2018 NAIC's Quarterly Statement Instructions, and the NAIC's Accounting Practices and Procedures Manual as of March 2018. The current rule adopted the 2017 National Association of Insurance Commissioners electronic transmission filing instructions, the 2016 and 2017 NAIC's Annual Statement Instructions, the 2016 and 2017 NAIC's Quarterly Statement Instructions, and the NAIC's Accounting Practices and Procedures Manual as of March 2017.

Sections 624.308(1), 624.424(1), F.S., are the rulemaking authority and laws implemented for this rule.

Michael Lawrence, Jr., is the attorney handling this rule. Attached are: 1) the proposed rule(s), 2) any incorporated materials, such as forms; and 3) copies of the rulemaking statutory authority and law implemented.

Approved for signature:

  
for Anoush Brangaccio, General Counsel

Approved for submission to Financial Services  
Commission:

  
David Altmaier, Commissioner  
Office of Insurance Regulation

### **690-137.001 Annual and Quarterly Reporting Requirements.**

(1) The purpose of this rule is to establish uniform requirements reporting of annual and quarterly statement information for all authorized insurers as defined in Section 624.09, F.S.

(2) Each authorized insurer shall file with the Office a full and true statement of its financial condition, transactions, and affairs.

(a) An annual statement covering the preceding calendar year shall be filed on or before March 1, and quarterly statements covering the periods ending on March 31, June 30, and September 30 shall be filed within 45 calendar days after each such date.

(b) The Office shall grant an extension of time for filing an annual or quarterly statement if there exist conditions beyond the control of the authorized insurer, such as rehabilitation pursuant to Chapter 631, F.S., or the laws of the state of domicile; severe damage to the insurer's physical premises by a natural or man-made disaster; or some other reason of similar gravity and severity. The extension shall be for the amount of time reasonable to file under the conditions which justified the extension.

(c) For purposes of this rule, the requirement that statements be filed with the Office means that the statement has been transmitted electronically to the National Association of Insurance Commissioners and that the executed Jurat page of said statement has been transmitted electronically to the Office via the Regulatory Electronic Filing System, "REFS." The date affixed by the Office's electronic data processing system shall serve as evidence of the timeliness of the statement. Annual and quarterly statements in any other format shall not be submitted to the Office.

(3) Annual and Quarterly Statement Reporting.

(a) Each insurer shall submit its annual and quarterly statement information electronically to the National Association of Insurance Commissioners in accordance with the electronic filing instructions specified in paragraph (3)(b), below.

(b)1. The National Association of Insurance Commissioners electronic transmission filing instructions (Financial Internet Filing Online User's Guide 2018 ~~2017~~) are hereby adopted and incorporated by reference, [www.flrules.org/](http://www.flrules.org/) ~~/~~,

2. A copy of these specifications may be obtained from the National Association of Insurance Commissioners at [http://www.naic.org/industry\\_financial\\_filing.htm](http://www.naic.org/industry_financial_filing.htm).

(4) Manuals Adopted.

(a) Annual statements shall be prepared in accordance with the following manuals, which are hereby adopted and incorporated by reference:

1. The NAIC's Annual Statement Instructions, Property and Casualty, 2017 ~~2016~~,
2. The NAIC's Annual Statement Instructions, Life, Accident and Health, 2017 ~~2016~~,
3. The NAIC's Annual Statement Instructions, Health, 2017 ~~2016~~,
4. The NAIC's Annual Statement Instructions, Title, 2017 ~~2016~~; and,
5. The NAIC's Accounting Practices and Procedures Manual, as of March 2017 ~~2016~~.

(b) Quarterly statements shall be prepared in accordance with the following manuals, which are hereby adopted and incorporated by reference:

1. The NAIC's Quarterly Statement Instructions, Property and Casualty, 2018 ~~2017~~,
2. The NAIC's Quarterly Statement Instructions, Life, Accident and Health, 2018 ~~2017~~,
3. The NAIC's Quarterly Statement Instructions, Health, 2018 ~~2017~~,
4. The NAIC's Quarterly Statement Instructions, Title, 2018 ~~2017~~; and,
5. The NAIC's Accounting Practices and Procedures Manual, as of March 2018 ~~2017~~.

(c) Copies of the manuals are available:

1. From the National Association of Insurance Commissioners at <http://www.naic.org>; and,
2. For inspection during regular business hours at the Office of Insurance Regulation, Larson Building, 200 East Gaines Street, Tallahassee, Florida 32399-0300.

*Rulemaking Authority 624.308(1), 624.424(1) FS. Law Implemented 624.424(1) FS. History—New 3-31-92, Amended 8-24-93, 4-9-95, 4-9-97, 4-4-99, 11-30-99, 2-11-01, 4-5-01, 12-4-01, 12-25-01, 8-18-02, 7-27-03, Formerly 4-137.001, Amended 1-6-05, 9-15-05, 1-25-07, 3-16-08, 3-4-09, 1-4-10, 9-28-11, 1-28-13, 9-15-13, 7-28-15, 10-25-16, 7-30-17, Amended \_\_\_\_\_.*

**624.308 Rules.--**

- (1) The department and the commission may each adopt rules pursuant to ss. 120.536(1) and 120.54 to implement provisions of law conferring duties upon the department or the commission, respectively.

**624.424 Annual statement and other information.--**

(1)(a) Each authorized insurer shall file with the office full and true statements of its financial condition, transactions, and affairs. An annual statement covering the preceding calendar year shall be filed on or before March 1, and quarterly statements covering the periods ending on March 31, June 30, and September 30 shall be filed within 45 days after each such date. The office may, for good cause, grant an extension of time for filing of an annual or quarterly statement. The statements shall contain information generally included in insurers' financial statements prepared in accordance with generally accepted insurance accounting principles and practices and in a form generally utilized by insurers for financial statements, sworn to by at least two executive officers of the insurer or, if a reciprocal insurer, by the oath of the attorney in fact or its like officer if a corporation. To facilitate uniformity in financial statements and to facilitate office analysis, the commission may by rule adopt the form for financial statements approved by the National Association of Insurance Commissioners in 2002, and may adopt subsequent amendments thereto if the methodology remains substantially consistent, and may by rule require each insurer to submit to the office or such organization as the office may designate all or part of the information contained in the financial statement in a computer-readable form compatible with the electronic data processing system specified by the office.

(b) Each insurer's annual statement must contain a statement of opinion on loss and loss adjustment expense reserves made by a member of the American Academy of Actuaries or by a qualified loss reserve specialist, under criteria established by rule of the commission. In adopting the rule, the commission must consider any criteria established by the National Association of Insurance Commissioners. The office may require semiannual updates of the annual statement of opinion as to a particular insurer if the office has reasonable cause to believe that such reserves are understated to the extent of materially misstating the financial position of the insurer. Workpapers in support of the statement of opinion must be provided to the office upon request. This paragraph does not apply to life insurance or title insurance.

(c) The commission may by rule require reports or filings required under the insurance code to be submitted by electronic means in a computer-readable form compatible with the electronic data processing equipment specified by the commission.



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**M E M O R A N D U M**

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**DATE:** November 15, 2018  
**TO:** David Altmaier, Commissioner, Office of Insurance Regulation  
**THROUGH:** Anoush Brangaccio, General Counsel  
**FROM:** Michael Lawrence, Jr., Assistant General Counsel  
**SUBJECT:** Cabinet Agenda for December 4, 2018  
Request for Approval to Publish Amendments to  
Rule 69O-138.001  
Assignment # 227526-18

The Office of Insurance Regulation requests that these proposed rule amendments be presented to the Cabinet aides on or before November 28, 2018, and to the Financial Services Commission on December 4, 2018.

These rules are being amended to adopt the 2017 and 2018 National Association of Insurance Commissioners Financial Condition Examiners Handbooks. The current rule adopted the 2016 and 2017 versions of these handbooks.


Sections 624.308(1), 624.316(1)(c), F.S., are the rulemaking authority and laws implemented for this rule.

Michael Lawrence, Jr., is the attorney handling this rule. Attached are: 1) the proposed rule(s), 2) any incorporated materials, such as forms; and 3) copies of the rulemaking statutory authority and law implemented.

Approved for signature:

  
Anoush Brangaccio, General Counsel

Approved for submission to Financial Services  
Commission:

  
David Altmaier, Commissioner  
Office of Insurance Regulation

**690-138.001 NAIC Financial Condition Examiners Handbook Adopted.**

(1)(a) The National Association of Insurance Commissioners Financial Condition Examiners Handbook 2018 ~~2017~~, is hereby adopted and incorporated by reference.

(b) The National Association of Insurance Commissioners Financial Condition Examiners Handbook 2017 ~~2016~~, is hereby adopted and incorporated by reference.

(2) Financial examinations by the Office shall be performed in substantial conformity with the methodology outlined in the Handbook, so long as that methodology is consistent with statutory accounting principles and the Florida Insurance Code.

(3) A copy of the Examiners Handbook may be:

(a) Obtained from the National Association of Insurance Commissioners, at <http://www.naic.org>, or

(b) Inspected during regular business hours at the Office of Insurance Regulation, Larson Building, 200 E. Gaines St., Tallahassee, Florida 32399-0300.

*Rulemaking Authority 624.308(1), 624.316(1)(c) FS. Law Implemented 624.316(1)(c) FS. History—New 3-30-92, Amended 4-9-97, 4-4-99, 11-30-99, 2-11-01, 12-25-01, 8-18-02, 7-27-03, Formerly 4-138.001, Amended 1-6-05, 9-15-05, 1-25-07, 3-16-08, 3-4-09, 1-4-10, 11-2-11, 1-28-13, 9-15-13, 7-28-15, 10-25-16, 7-30-17, Amended \_\_\_\_\_.*

**624.308 Rules.--**

- (1) The department and the commission may each adopt rules pursuant to ss. 120.536(1) and 120.54 to implement provisions of law conferring duties upon the department or the commission, respectively.

**624.316 Examination of insurers.—**

- (1)(c) The office shall examine each insurer according to accounting procedures designed to fulfill the requirements of generally accepted insurance accounting principles and practices and good internal control and in keeping with generally accepted accounting forms, accounts, records, methods, and practices relating to insurers. To facilitate uniformity in examinations, the commission may adopt, by rule, the Market Conduct Examiners Handbook and the Financial Condition Examiners Handbook of the National Association of Insurance Commissioners, 2002, and may adopt subsequent amendments thereto, if the examination methodology remains substantially consistent.

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**M E M O R A N D U M**

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**DATE:** November 15, 2018  
**TO:** David Altmaier, Commissioner, Office of Insurance Regulation  
**THROUGH:** Anoush Brangaccio, General Counsel  
**FROM:** Michael Lawrence, Jr., Assistant General Counsel  
**SUBJECT:** Cabinet Agenda for December 4, 2018  
Request for Final Approval to Adopt Amendments to  
Rule 69O-125.003  
Assignment # 220772-18

The Office of Insurance Regulation requests that these proposed rule amendments be presented to the Cabinet aides on or before November 28, 2018, and to the Financial Services Commission on December 4, 2018, with a request for Final Approval to Adopt the proposed rules.

The notice of proposed rules was published on August 1, 2018, in Volume 44, No. 149, of the *Register*. A hearing was held. Insurers are required to report the refusal or limitation of life insurance policies based on the applicant's past or future lawful foreign travel. The amendment removes a reference to annuity contracts.

Sections 626.9541(1)(dd)3.; 626.9611; 626.951; 626.9521; 626.9541(1)(g), (dd), F.S., are the rulemaking authority and laws implemented for this rule.

The Legal Services Office has communicated with the Joint Administrative Procedures Committee and confirmed that their review of the rules has been completed.

Michael Lawrence, Jr., is the attorney handling this rule. Attached are: 1) the proposed rule(s); 2) any incorporated materials, such as forms; 3) copies of the rulemaking statutory authority and law implemented.

Approved for signature:

  
Anoush Brangaccio, General Counsel

Approved for submission to Financial Services  
Commission:

  
David Altmaier, Commissioner  
Office of Insurance Regulation

**69O-125.003 Unfair Discrimination Because of Travel Plans.**

(1) through (7) No Change

(8)(a) Insurers are required to maintain the following data. The data for each calendar year shall be submitted to the Office annually by January 31 of the following year:

1. The number of applications under which a policy or certificate of life insurance ~~or an annuity contract~~ was denied,
2. The number of applications under which a policy or certificate of life insurance's ~~or an annuity contract's~~ continuation was refused; and,
3. The number of applications under which a policy or certificate of life insurance ~~or an annuity contract's~~ coverage was limited.

(b) through (c) No Change

(9) through (10) No Change

*Rulemaking Authority 626.9541(1)(dd)3., 626.9611 FS. Law Implemented 626.951, 626.9521, 626.9541(1)(g), (dd) FS. History—  
New 7-6-06, Amended 11-1-07, Amended*

626.9541 Unfair methods of competition and unfair or deceptive acts or practices defined.—

(1) UNFAIR METHODS OF COMPETITION AND UNFAIR OR DECEPTIVE ACTS.—The following are defined as unfair methods of competition and unfair or deceptive acts or practices:

(dd) Life insurance limitations based on past foreign travel experiences or future foreign travel plans.—

3. The commission may adopt rules pursuant to ss. 120.536(1) and 120.54 necessary to implement this paragraph and may provide for limited exceptions that are based upon national or international emergency conditions that affect the public health, safety, and welfare and that are consistent with public policy.

(g) Unfair discrimination.—

1. Knowingly making or permitting unfair discrimination between individuals of the same actuarially supportable class and equal expectation of life, in the rates charged for a life insurance or annuity contract, in the dividends or other benefits payable thereon, or in any other term or condition of such contract.

2. Knowingly making or permitting unfair discrimination between individuals of the same actuarially supportable class, as determined at the time of initial issuance of the coverage, and essentially the same hazard, in the amount of premium, policy fees, or rates charged for a policy or contract of accident, disability, or health insurance, in the benefits payable thereunder, in the terms or conditions of such contract, or in any other manner.

3. For a health insurer, life insurer, disability insurer, property and casualty insurer, automobile insurer, or managed care provider to underwrite a policy, or refuse to issue, reissue, or renew a policy, refuse to pay a claim, cancel or otherwise terminate a policy, or increase rates based upon the fact that an insured or applicant who is also the proposed insured has made a claim or sought or should have sought medical or psychological treatment in the past for abuse, protection from abuse, or shelter from abuse, or that a claim was caused in the past by, or might occur as a result of, any future assault, battery, or sexual assault by a family or household member upon another family or household member as defined in s. 741.28. A health insurer, life insurer, disability insurer, or managed care provider may refuse to underwrite, issue, or renew a policy based on the applicant's medical condition, but may not consider whether such condition was caused by an act of abuse. For purposes of this section, the term "abuse" means the occurrence of one or more of the following acts:

- a. Attempting or committing assault, battery, sexual assault, or sexual battery;
- b. Placing another in fear of imminent serious bodily injury by physical menace;
- c. False imprisonment;
- d. Physically or sexually abusing a minor child; or
- e. An act of domestic violence as defined in s. 741.28.

This subparagraph does not prohibit a property and casualty insurer or an automobile insurer from excluding coverage for intentional acts by the insured if such exclusion is not an act of unfair discrimination as defined in this paragraph.

4. For a personal lines property or personal lines automobile insurer to:

- a. Refuse to issue, reissue, or renew a policy; cancel or otherwise terminate a policy; or charge an unfairly discriminatory rate in this state based on the lawful use, possession, or ownership of a firearm or ammunition by the insurance applicant, insured, or a household member of the applicant or insured. This sub-subparagraph does not prevent an insurer

from charging a supplemental premium that is not unfairly discriminatory for a separate rider voluntarily requested by the insurance applicant to insure a firearm or a firearm collection whose value exceeds the standard policy coverage.

b. Disclose the lawful ownership or possession of firearms of an insurance applicant, insured, or household member of the applicant or insured to a third party or an affiliated entity of the insurer unless the insurer discloses to the applicant or insured the specific need to disclose the information and the applicant or insured expressly consents to the disclosure, or the disclosure is necessary to quote or bind coverage, continue coverage, or adjust a claim. For purposes of underwriting and issuing insurance coverage, this subparagraph does not prevent the sharing of information between an insurance company and its licensed insurance agent if a separate rider has been voluntarily requested by the policyholder or prospective policyholder to insure a firearm or a firearm collection whose value exceeds the standard policy coverage.

626.9611 Rules.—

(1) The department or commission may, in accordance with chapter 120, adopt reasonable rules as are necessary or proper to identify specific methods of competition or acts or practices which are prohibited by s. 626.9541 or s. 626.9551, but the rules shall not enlarge upon or extend the provisions of ss. 626.9541 and 626.9551.

(2) The department and the commission shall, in accordance with chapter 120, adopt rules to protect members of the United States Armed Forces from dishonest or predatory insurance sales practices by insurers and insurance agents. The rules shall identify specific false, misleading, deceptive, or unfair methods of competition, acts, or practices which are prohibited by s. 626.9541 or s. 626.9551. The rules shall be based upon model rules or model laws adopted by the National Association of Insurance Commissioners which identify certain insurance practices involving the solicitation or sale of insurance and annuities to members of the United States Armed Forces which are false, misleading, deceptive, or unfair.

626.951 Declaration of purpose.—

(1) The purpose of this part is to regulate trade practices relating to the business of insurance in accordance with the intent of Congress as expressed in the Act of Congress of March 9, 1945 (Pub. L. No. 15, 79th Congress), by defining, or providing for the determination of, all such practices in this state which constitute unfair methods of competition or unfair or deceptive acts or practices and by prohibiting the trade practices so defined or determined.

(2) This part shall be entitled the "Unfair Insurance Trade Practices Act."

626.9521 Unfair methods of competition and unfair or deceptive acts or practices prohibited; penalties.—

(1) No person shall engage in this state in any trade practice which is defined in this part as, or determined pursuant to s. 626.951 or s. 626.9561 to be, an unfair method of competition or an unfair or deceptive act or practice involving the business of insurance.

(2) Except as provided in subsection (3), any person who violates any provision of this part is subject to a fine in an amount not greater than \$5,000 for each nonwillful violation and not greater than \$40,000 for each willful violation. Fines under this subsection imposed against an insurer may not exceed an aggregate amount of \$20,000 for all nonwillful violations arising out of the same action or an aggregate amount of \$200,000 for all willful violations arising out of the same action. The fines may be imposed in addition to any other applicable penalty.

(3)(a) If a person violates s. 626.9541(1)(l), the offense known as "twisting," or violates s. 626.9541(1)(aa), the offense known as "churning," the person commits a misdemeanor of the first degree, punishable as provided in s. 775.082, and an administrative fine not greater than \$5,000 shall be imposed for each nonwillful violation or an administrative fine not greater than \$75,000 shall be imposed for each willful violation. To impose an administrative fine for a willful violation under this paragraph, the practice of "churning" or "twisting" must involve fraudulent conduct.

(b) If a person violates s. 626.9541(1)(ee) by willfully submitting fraudulent signatures on an application or policy-related document, the person commits a felony of the third degree, punishable as provided in s. 775.082, and an administrative fine not greater than \$5,000 shall be imposed for each nonwillful violation or an administrative fine not greater than \$75,000 shall be imposed for each willful violation.

(c) Administrative fines under this subsection may not exceed an aggregate amount of \$50,000 for all nonwillful violations arising out of the same action or an aggregate amount of \$250,000 for all willful violations arising out of the same action.

(4) A licensee must make all reasonable efforts to ascertain the consumer's age at the time an insurance application is completed.

(5) If a consumer who is a senior citizen is a victim, a video deposition of the victim may be used for any purpose in any administrative proceeding conducted pursuant to chapter 120 if all parties are given proper notice of the deposition in accordance with the Florida Rules of Civil Procedure.



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**M E M O R A N D U M**

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**DATE:** November 15, 2018  
**TO:** David Altmaier, Commissioner, Office of Insurance Regulation  
**THROUGH:** Anoush Brangaccio, General Counsel  
**FROM:** Michael Lawrence, Jr., Assistant General Counsel  
**SUBJECT:** Cabinet Agenda for December 4, 2018  
Request for Final Approval to Adopt Amendments to  
Rule 69O-137.002  
Assignment # 220771-18

The Office of Insurance Regulation requests that this proposed rule amendment be presented to the Cabinet aides on or before November 28, 2018, and to the Financial Services Commission on December 4, 2018, with a request for Final Approval to Adopt the proposed rules.

The notice of proposed rules was published on August 1, 2018, in Volume 44, No. 149, of the *Register*. A hearing was held. The American Institute of CPAs has updated the professional standards guidance that applies to annual audited financial statements. The amendment adopts these updated standards.

Sections 624.308(1); 624.4085; 624.424(8)(e); 624.307(1); 624.324; 624.424(8), F.S., are the rulemaking authority and laws implemented for this rule.

The Legal Services Office has communicated with the Joint Administrative Procedures Committee and confirmed that their review of the rules has been completed.

Michael Lawrence, Jr., is the attorney handling this rule. Attached are: 1) the proposed rule(s); 2) any incorporated materials, such as forms; 3) copies of the rulemaking statutory authority and law implemented.

Approved for signature:

  
for Anoush Brangaccio, General Counsel

Approved for submission to Financial Services  
Commission:

  
David Altmaier, Commissioner  
Office of Insurance Regulation

69O-137.002 Annual Audited Financial Reports.

(1) through (8) No change.

(9) Scope of Audit and Report of Independent Certified Public Accountant. Financial statements furnished pursuant to subsection (5), above, shall be examined by the independent certified public accountant. The audit of the insurer's financial statements shall be conducted in accordance with generally accepted auditing standards. In accordance with AU-C 610 AU-Section 319 of the Professional Standards of the AICPA, Using the Work of Internal Auditors, effective 12/15/14, and AU-C Section 940 of the Professional Standards of the AICPA, An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements, effective 12/15/16, Consideration of Internal Control in a Financial Statement Audit the independent certified public accountant should obtain an understanding of internal control sufficient to plan the audit. To the extent required by AU-C 610 and AU-C Section 940 AU-319, for those insurers required to file a Management's Report of Internal Control over Financial Reporting pursuant to subsection (16), the independent certified public accountant should consider (as that term is defined in AU-Section 120 of the Professional Standards of the AICPA, AU-C 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards, effective 12/15/12 Defining Professional Requirements in Statements on Auditing Standards) the most recently available report in planning and performing the audit of the statutory financial statements. Consideration should also be given to the other procedures illustrated in the Financial Condition Examiner's Handbook promulgated by the National Association of Insurance Commissioners (incorporated by reference in Rule 69O-138.001, F.A.C.) as the independent Certified Public Accountant deems necessary.

(10) Notification of Adverse Financial Condition.

(a) through (b) No change.

(c) If the accountant, subsequent to the date of the Audited Financial Report filed pursuant to this rule, becomes aware of facts which might have affected his report, the Office notes the obligation of the accountant to take such action as prescribed in AU-C 560 Volume 1, Section AU-561 of the Professional Standards of the AICPA, Subsequent Events and Subsequently Discovered Facts, effective 12/15/12.

(11) Communication of Internal Control Related Matters Noted in an Audit.

(a) In addition to the annual Audited Financial Report, each insurer shall furnish the Office with a written communication as to any unremediated material weaknesses in its Internal control over financial reporting noted during the audit. Such communication shall be prepared by the accountant within sixty (60) days after the filing of the annual Audited Financial Report, and shall contain a description of any unremediated material weakness (as the term material weakness is defined by AU-C 265 AU-Section 325 of the Professional Standards of the AICPA, Communicating Internal Control Related Matters Identified in an Audit, effective 12/15/12, as of December 31 immediately preceding (so as to coincide with the Audited Financial Report discussed in subsection (4)) in the insurer's Internal control over financial reporting noted by the accountant during the course of their audit of the financial statements. If no unremediated material weaknesses were noted, the communication should so state.

(b) No change.

(12) through (13) No change.

(14) Requirements for Audit Committee.

This section shall not apply to foreign or alien insurers licensed in this state or an insurer that is a SOX Compliant Entity or a direct or indirect wholly-owned subsidiary of a SOX Compliant Entity.

(a) through (e) No change.

(f)1. The Audit committee shall require the accountant that performs for an insurer any audit required by this regulation to timely report to the Audit committee in accordance with the requirements of AU-C 260 AU-Section 380 of the Professional Standards of the AICPA, The Auditor's Communication With Those Charged with Governance, effective 12/15/12, Communication with Audit Committees, including:

a. through c. No change.

2. If an insurer is a member of an insurance holding company system, the reports required by subparagraph (f)1., may be provided to the Audit committee on an aggregate basis for insurers in the holding company system, provided that any substantial differences among insurers in the system are identified to the Audit committee.

(g) through (h) No Change.

(15) through (19) No change.

(20) Standards Incorporated by Reference.

(a) The following standards are hereby incorporated by reference:

1. AU-C 610 AU-Section 319 of the Professional Standards of the AICPA, Using the Work of Internal Auditors, effective 12/15/14; Consideration of Internal Control in a Financial Statement Audit,

2. AU-C 200 AU Section 120 of the Professional Standards of the AICPA, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, effective 12/15/12; *Defining Professional Requirements in Statements on Auditing Standards*,

3. AU-C 560 Volume 1, Section AU 561 of the Professional Standards of the AICPA, *Subsequent Events and Subsequently Discovered Facts*, effective 12/15/12;

4. AU-C 265 AU Section 325 of the Professional Standards of the AICPA, *Communicating Internal Control Related Matters Identified in an Audit* effective 12/15/12 ; and,

5. AU-C 260 AU Section 380 of the Professional Standards of the AICPA, *The Auditor's Communication With Those Charged With Governance*, effective 12/15/12; and *Communication with Audit Committees*.

6. AU-C Section 940 of the Professional Standards of the AICPA, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements*, effective 12/15/16.

(b) The standards incorporated in this section are available :

1. From at the American Institute of Certified Public Accountants' CPAs (AICPA) website at:  
<http://www.aicpa.org/Publications> ; and, -

2. For inspection during regular business hours at the Office of Insurance Regulation, Larson Building, 200 East Gaines Street, Tallahassee, Florida 32399-0300.

*Rulemaking Authority 624.308(1), 624.4085, 624.424(8)(e) FS. Law Implemented 624.307(1), 624.324, 624.424(8) FS. History—New 3-31-92, Amended 3-14-94, 8-17-98, 4-4-01, 8-14-02, Formerly 4-137.002, Amended 11-3-05, 9-21-10,\_\_\_\_\_.*

624.308 Rules.—

(1) The department and the commission may each adopt rules pursuant to ss. 120.536(1) and 120.54 to implement provisions of law conferring duties upon the department or the commission, respectively.

624.307 General powers; duties.—

(1) The department and office shall enforce the provisions of this code and shall execute the duties imposed upon them by this code, within the respective jurisdiction of each, as provided by law.

624.4085 Risk-based capital requirements for insurers.—

(1) As used in this section, the term:

- (a) "Adjusted risk-based capital report" means a risk-based capital report that has been adjusted by the office in accordance with this section.
- (b) "Authorized control level risk-based capital" means the number determined under the risk-based capital formula in the risk-based capital instructions.
- (c) "Company action level risk-based capital" means the product of 2.0 and an insurer's authorized control level risk-based capital.
- (d) "Corrective order" means an order issued by the office specifying corrective actions that the office has determined are required.
- (e) "Domestic insurer" means any insurer domiciled in this state.
- (f) "Foreign insurer" means any insurer that is authorized or eligible to do business in this state but that is not domiciled in this state.
- (g) "Life and health insurer" means an insurer authorized or eligible under the Florida Insurance Code to underwrite life or health insurance. The term includes a property and casualty insurer that writes accident and health insurance only. Effective January 1, 2015, the term also includes a health maintenance organization that is authorized in this state and one or more other states, jurisdictions, or countries and a prepaid limited health service organization that is authorized in this state and one or more other states, jurisdictions, or countries.
- (h) "Mandatory control level risk-based capital" means the product of 0.70 and the authorized control level risk-based capital.
- (i) "Negative trend" means, with respect to a life and health insurer, a negative trend over a period of time, as determined in accordance with the trend test calculation included in the risk-based capital instructions.
- (j) "Property and casualty insurer" means any insurer licensed under the Florida Insurance Code, but does not include a single-line mortgage guaranty insurer, financial guaranty insurer, or title insurer or a life and health insurer.
- (k) "Regulatory action level risk-based capital" means the product of 1.5 and an insurer's authorized control level risk-based capital.
- (l) "Revised risk-based capital plan" means the revision of the risk-based capital plan which is prepared by an insurer after the office rejects the original plan.
- (m) "Risk-based capital instructions" means the instructions for preparing a risk-based capital report as adopted by the National Association of Insurance Commissioners.
- (n) "Risk-based capital level" means an insurer's company action level risk-based capital, regulatory action level risk-based capital, authorized control level risk-based capital, or mandatory control level risk-based capital.
- (o) "Risk-based capital plan" means a comprehensive financial plan specified in paragraph (4)(b).
- (p) "Risk-based capital report" means the report required in subsection (2).
- (q) "Total adjusted capital" means the sum of:
  - 1. An insurer's statutory capital and surplus; and

2. Any other item required by the risk-based capital instructions.

(2)(a) Each domestic insurer that is subject to this section shall, on or before March 1 of each year, prepare and file with the National Association of Insurance Commissioners a report of its risk-based capital levels as of the end of the calendar year just ended, in a form and containing the information required in the risk-based capital instructions. In addition, each domestic insurer shall file a printed copy of its risk-based capital report:

1. With the office on or before March 1 of each year.

2. With the insurance department in any other state in which the insurer is authorized to do business, if that department has notified the insurer of its request in writing, in which case the insurer shall file its risk-based capital report not later than the later of:

a. Fifteen days after the receipt of notice to file its risk-based capital report with that state; or

b. March 1.

(b) The comparison of an insurer's total adjusted capital to any of its risk-based capital levels is a regulatory tool that may indicate the need for possible corrective action with respect to the insurer, and may not be used as a means to rank insurers generally. Therefore, except as otherwise required under this section, the making, publishing, disseminating, circulating, or placing before the public, or causing, directly or indirectly, to be made, published, disseminated, circulated, or placed before the public, in a newspaper, magazine, or other publication, or in the form of a notice, circular, pamphlet, letter, or poster, or over any radio or television station, or in any other way, an advertisement, announcement, or statement containing an assertion, representation, or statement with regard to the risk-based capital levels of any insurer, or of any component derived in the calculation, by any insurer, agent, broker, or other person engaged in any manner in the insurance business would be misleading and is therefore prohibited; however, if any materially false statement with respect to the comparison regarding an insurer's total adjusted capital to its risk-based capital levels (or any of them) or an inappropriate comparison of any other amount to the insurer's risk-based capital levels is published in any written publication and the insurer is able to demonstrate to the office with substantial proof the falsity or inappropriateness of the statement, the insurer may publish in a written publication an announcement the sole purpose of which is to rebut the materially false statement.

(c) The office shall use the risk-based capital instructions, risk-based capital reports, adjusted risk-based capital reports, risk-based capital plans, and revised risk-based capital plans solely for monitoring the solvency of insurers and assessing the need for corrective action with respect to insurers. The office may not use that information for ratemaking, as evidence in any rate proceeding, or for calculating or deriving any elements of an appropriate premium level or rate of return for any line of insurance which an insurer or an affiliate of such insurer is authorized to write.

(d) A life and health insurer's risk-based capital is determined in accordance with the formula set forth in the risk-based capital instructions. The formula takes into account and may adjust for the covariance between:

1. The risk with respect to the insurer's assets;

2. The risk of adverse insurance experience with respect to the insurer's liabilities and obligations;

3. The interest rate risk with respect to the insurer's business; and

4. Any other business or other relevant risk set out in the risk-based capital instructions,

determined in each case by applying the factors in the manner set forth in the risk-based capital instructions.

(e) A property and casualty insurer's risk-based capital is determined in accordance with the formula set forth in the risk-based capital instructions. The formula takes into account and may adjust for the covariance between:

1. The asset risk;
2. The credit risk;
3. The underwriting risk; and
4. Any other business or other relevant risk set out in the risk-based capital instructions,

determined in each case by applying the factors in the manner set forth in the risk-based capital instructions.

(f) The Legislature finds that an excess of capital over the amount produced by the risk-based capital requirements and the formulas, schedules, and instructions specified in this section is a desirable goal with respect to the business of insurance. Accordingly, insurers should seek to maintain capital above the risk-based capital levels required by this section. Additional capital is used and useful in the insurance business and helps to secure an insurer against various risks inherent in, or affecting, the business of insurance and not accounted for or only partially measured by the risk-based capital requirements contained in this section.

(g) If a domestic insurer files a risk-based capital report that the office finds is inaccurate, the office shall adjust the risk-based capital report to correct the inaccuracy and shall notify the insurer of the adjustment. The notice must state the reason for the adjustment. A risk-based capital report that is so adjusted is referred to as the adjusted risk-based capital report. The adjusted risk-based capital report must also be filed by the insurer with the National Association of Insurance Commissioners.

(3)(a) A company action level event includes:

1. The filing of a risk-based capital report by an insurer which indicates that:
  - a. The insurer's total adjusted capital is greater than or equal to its regulatory action level risk-based capital but less than its company action level risk-based capital;
  - b. If a life and health insurer reports using the life and health annual statement instructions, the insurer has total adjusted capital that is greater than or equal to its company action level risk-based capital, but is less than the product of its authorized control level risk-based capital and 3.0, and has a negative trend;
  - c. Effective January 1, 2015, if a life and health or property and casualty insurer reports using the health annual statement instructions, the insurer or organization has total adjusted capital that is greater than or equal to its company action level risk-based capital, but is less than the product of its authorized control level risk-based capital and 3.0, and triggers the trend test determined in accordance with the trend test calculation included in the Risk-Based Capital Forecasting and Instructions, Health, updated annually by the NAIC; or
  - d. If a property and casualty insurer reports using the property and casualty annual statement instructions, the insurer has total adjusted capital that is greater than or equal to its company action level risk-based capital, but less than the product of its authorized control level risk-based capital and 3.0, and triggers the trend test determined in accordance with the trend test calculation included in the Risk-Based Capital Forecasting and Instructions, Property/Casualty, updated annually by the NAIC;
2. The notification by the office to the insurer of an adjusted risk-based capital report that indicates an event in subparagraph 1., unless the insurer challenges the adjusted risk-based capital report under subsection (7); or
3. If, under subsection (7), an insurer challenges an adjusted risk-based capital report that indicates an event in subparagraph 1., the notification by the office to the insurer that the office has, after a hearing, rejected the insurer's challenge.

(b) If a company action level event occurs, the insurer shall prepare and submit to the office a risk-based capital plan, which must:

1. Identify the conditions that contribute to the company action level event;
2. Contain proposals of corrective actions that the insurer intends to take and that are reasonably expected to result in the elimination of the company action level event;
3. Provide projections of the insurer's financial results in the current year and at least the 4 succeeding years, both in the absence of proposed corrective actions and giving effect to the proposed corrective actions, including projections of statutory operating income, net income, capital, and surplus. The projections for both new and renewal business may include separate projections for each major line of business and, if separate projections are provided, must separately identify each significant income, expense, and benefit component;
4. Identify the key assumptions affecting the insurer's projections and the sensitivity of the projections to the assumptions; and
5. Identify the quality of, and problems associated with, the insurer's business, including, but not limited to, its assets, anticipated business growth and associated surplus strain, extraordinary exposure to risk, mix of business, and any use of reinsurance.

(c) The risk-based capital plan must be submitted:

1. Within 45 days after the company action level event; or
2. If the insurer challenges an adjusted risk-based capital report under subsection (7), within 45 days after notification to the insurer that the office has, after a hearing, rejected the insurer's challenge.

(d) Within 60 days after the submission by an insurer of a risk-based capital plan to the office, the office shall notify the insurer whether the risk-based capital plan must be implemented or is, in the judgment of the office, unsatisfactory. If the office determines that the risk-based capital plan is unsatisfactory, the notification to the insurer must set forth the reasons for the determination and may set forth proposed revisions. Upon notification from the office, the insurer shall prepare a revised risk-based capital plan, which may incorporate by reference any revisions proposed by the office, and shall submit the revised risk-based capital plan to the office:

1. Within 45 days after the notification from the office; or
2. If the insurer challenges the notification from the office under subsection (7), within 45 days after a notification to the insurer that the office has, after a hearing, rejected the insurer's challenge.

(e) If the office notifies an insurer that the insurer's risk-based capital plan or revised risk-based capital plan is unsatisfactory, the office may, at its discretion and subject to the insurer's right to a hearing under subsection (7), specify in the notification that the notification is a regulatory action level event.

(f) Each domestic insurer that files a risk-based capital plan or a revised risk-based capital plan with the office shall file a copy of the risk-based capital plan or the revised risk-based capital plan with the insurance department in any other state in which the insurer is authorized to do business if:

1. That state has a risk-based capital law that is substantially similar to paragraph (8)(a); and
2. The insurance department of that state has notified the insurer of its request for the filing in writing, in which case the insurer shall file a copy of the risk-based capital plan or the revised risk-based capital plan in that state no later than the later of:
  - a. Fifteen days after the receipt of notice to file a copy of its risk-based capital plan or revised risk-based capital plan with the state; or
  - b. The date on which the risk-based capital plan or the revised risk-based capital plan is filed under paragraph (c) or paragraph (d).

(4)(a) A regulatory action level event includes:

1. The filing of a risk-based capital report by the insurer which indicates that the insurer's total adjusted capital is greater than or equal to its authorized control level risk-based capital but is less than its regulatory action level risk-based capital;
  2. The notification by the office to the insurer of an adjusted risk-based capital report that indicates the event described in subparagraph 1., unless the insurer challenges the adjusted risk-based capital report under subsection (7);
  3. If, under subsection (7), the insurer challenges an adjusted risk-based capital report that indicates the event described in subparagraph 1., the notification by the office to the insurer that the office has, after a hearing, rejected the insurer's challenge;
  4. The failure of the insurer to file a risk-based capital report by the filing date, unless the insurer provides an explanation for such failure which is satisfactory to the office and cures the failure within 10 days after the filing date;
  5. The failure of the insurer to submit a risk-based capital plan to the office within the time period set forth in paragraph (3)(c);
  6. Notification by the office to the insurer that:
    - a. The risk-based capital plan or the revised risk-based capital plan submitted by the insurer is, in the judgment of the office, unsatisfactory; and
    - b. This notification constitutes a regulatory action level event with respect to the insurer, unless the insurer challenges the determination under subsection (7);
  7. If, under subsection (7), the insurer challenges a determination by the office under subparagraph 6., the notification by the office to the insurer that the office has, after a hearing, rejected the challenge;
  8. Notification by the office to the insurer that the insurer has failed to adhere to its risk-based capital plan or revised risk-based capital plan, but only if this failure has a substantial adverse effect on the ability of the insurer to eliminate the company action level event in accordance with its risk-based capital plan or revised risk-based capital plan and the office has so stated in the notification, unless the insurer challenges the determination under subsection (7); or
  9. If, under subsection (7), the insurer challenges a determination by the office under subparagraph 8., the notification by the office to the insurer that the office has, after a hearing, rejected the challenge.
- (b) If a regulatory action level event occurs, the office shall:
1. Require the insurer to prepare and submit a risk-based capital plan or, if applicable, a revised risk-based capital plan;
  2. Perform an examination pursuant to s. 624.316 or an analysis, as the office considers necessary, of the assets, liabilities, and operations of the insurer, including a review of the risk-based capital plan or the revised risk-based capital plan; and
  3. After the examination or analysis, issue a corrective order specifying such corrective actions as the office determines are required.
- (c) In determining corrective actions, the office shall consider any factor relevant to the insurer based upon the office's examination or analysis of the assets, liabilities, and operations of the insurer, including, but not limited to, the results of any sensitivity tests undertaken as provided in the risk-based capital instructions. The risk-based capital plan or the revised risk-based capital plan must be submitted:
1. Within 45 days after the occurrence of the regulatory action level event;
  2. If the insurer challenges an adjusted risk-based capital report under subsection (7), within 45 days after the notification to the insurer that the office has, after a hearing, rejected the insurer's challenge; or
  3. If the insurer challenges a revised risk-based capital plan under subsection (7), within 45 days after the notification to the insurer that the office has, after a hearing, rejected the insurer's challenge.
- (d) The office may retain actuaries, investment experts, and other consultants to review an insurer's risk-based capital plan or revised risk-based capital plan, examine or analyze



the assets, liabilities, and operations of an insurer, and formulate the corrective order with respect to the insurer. The fees, costs, and expenses relating to consultants must be borne by the affected insurer or by any other party as directed by the office.

(5)(a) An authorized control level event includes:

1. The filing of a risk-based capital report by the insurer which indicates that the insurer's total adjusted capital is greater than or equal to its mandatory control level risk-based capital but is less than its authorized control level risk-based capital;
2. The notification by the office to the insurer of an adjusted risk-based capital report that indicates the event in subparagraph 1., unless the insurer challenges the adjusted risk-based capital report under subsection (7);
3. If, under subsection (7), the insurer challenges an adjusted risk-based capital report that indicates the event in subparagraph 1., notification by the office to the insurer that the office has, after a hearing, rejected the insurer's challenge;
4. The failure of the insurer to respond, in a manner satisfactory to the office, to a corrective order, unless the insurer challenges the corrective order under subsection (7); or
5. If the insurer challenges a corrective order under subsection (7) and the office has, after a hearing, rejected the challenge or modified the corrective order, the failure of the insurer to respond, in a manner satisfactory to the office, to the corrective order after rejection or modification by the office.

(b) If an authorized control level event occurs, the office shall:

1. Take any action required under subsection (4) regarding the insurer with respect to which a regulatory action level event has occurred; or
2. If the office considers it to be in the best interests of the policyholders and creditors of the insurer and of the public, take any action as necessary to cause the insurer to be placed under regulatory control under chapter 631. An authorized control level event is sufficient ground for the department to be appointed as receiver as provided in chapter 631.

(6)(a) A mandatory control level event includes:

1. The filing of a risk-based capital report that indicates that the insurer's total adjusted capital is less than its mandatory control level risk-based capital;
2. Notification by the office to the insurer of an adjusted risk-based capital report that indicates the event in subparagraph 1., unless the insurer challenges the adjusted risk-based capital report under subsection (7); or
3. If, under subsection (7), the insurer challenges an adjusted risk-based capital report that indicates the event in subparagraph 1., notification by the office to the insurer that the office has, after a hearing, rejected the insurer's challenge.

(b) If a mandatory control level event occurs:

1. With respect to a life and health insurer, the office shall, after due consideration of s. 624.408, and effective January 1, 2015, ss. 636.045 and 641.225, take any action necessary to place the insurer under regulatory control, including any remedy available under chapter 631. A mandatory control level event is sufficient ground for the department to be appointed as receiver as provided in chapter 631. The office may forego taking action for up to 90 days after the mandatory control level event if the office finds there is a reasonable expectation that the event may be eliminated within the 90-day period.
2. With respect to a property and casualty insurer, the office shall, after due consideration of s. 624.408, take any action necessary to place the insurer under regulatory control, including any remedy available under chapter 631, or, in the case of an insurer that is not writing new business, may allow the insurer to continue to operate under the supervision of the office. In either case, the mandatory control level event is sufficient ground for the department to be appointed as receiver as provided in chapter 631. The office may forego taking action for up to 90 days after the mandatory control level event if the office finds there is a reasonable expectation that the event may be eliminated within the 90-day period.

(7)(a) An insurer has a right to a hearing before the office upon:

1. Notification to an insurer by the office of an adjusted risk-based capital report;
  2. Notification to an insurer by the office that the insurer's risk-based capital plan or revised risk-based capital plan is unsatisfactory, and that the notification constitutes a regulatory action level event with respect to such insurer;
  3. Notification to any insurer by the office that the insurer has failed to adhere to its risk-based capital plan or revised risk-based capital plan and that the failure has a substantial adverse effect on the ability of the insurer to eliminate the company action level event in accordance with its risk-based capital plan or its revised risk-based capital plan; or
  4. Notification to an insurer by the office of a corrective order with respect to the insurer.
- (b) At such hearing the insurer may challenge any determination or action by the office. The insurer shall notify the office of its request for a hearing within 5 days after receipt of the notification by the office under this subsection. Upon receipt of the request for a hearing, the office shall set a date for the hearing, which date must be no fewer than 10 nor more than 30 days after the date the office receives the insurer's request. The hearing must be conducted as provided in s. 624.324, with the right to appellate review under s. 120.68.
- (8)(a) Any foreign insurer shall, upon the written request of the office, submit to the office a risk-based capital report, as of the end of the calendar year just ended, no later than the later of:
1. The date a risk-based capital report is required to be filed by a domestic insurer under this section; or
  2. Fifteen days after the request is received by the foreign insurer.
- (b) Any foreign insurer shall, upon the written request of the office, promptly submit to the office a copy of any risk-based capital plan that is filed with the insurance department of another state.
- (c) The office may require a foreign insurer to file a risk-based capital plan if:
1. A company action level event, regulatory action level event, or authorized control level event occurs with respect to any foreign insurer as determined under the risk-based capital law of the state of domicile of the insurer, or, if there is no risk-based capital law in that state, under this section.
  2. The insurance department of the state of domicile of the foreign insurer fails to require the foreign insurer to file a risk-based capital plan in the manner specified under the risk-based capital law of that state, or, if there is no risk-based capital law in that state, under subsection (3).

The failure of the foreign insurer to file a risk-based capital plan with the office when required under this paragraph is a ground for the office to take any action under s. 624.418 which it determines is necessary.

- (d) If a mandatory control level event occurs with respect to any foreign insurer and a domiciliary receiver has not been appointed with respect to the foreign insurer under the rehabilitation and liquidation law of the state of domicile of the foreign insurer, the office may apply to the Circuit Court of Leon County and such event constitutes grounds for the department to be appointed as receiver as provided in chapter 631 with respect to the liquidation of property of foreign insurers found in this state. The occurrence of a mandatory control level event is a ground for such application.
- (9) There shall be no liability on the part of, and no cause of action shall arise against, the commission, department, or office, or their employees or agents, for any action taken by them in the performance of their powers and duties under this section.
- (10) The office shall transmit any notice that may result in regulatory action by registered mail, certified mail, or any other method of transmission. Notice is effective when the insurer receives it.

(11) This section is supplemental to the other laws of this state and does not preclude or limit any power or duty of the department or office under those laws or under the rules adopted under those laws.

(12) This section does not apply to a domestic property and casualty insurer that meets all of the following conditions:

(a) Writes direct business only in this state;

(b) Writes direct annual premiums of \$2 million or less; and

(c) Assumes no reinsurance in excess of 5 percent of direct premiums written.

(13) The commission may adopt rules to administer this section, including, but not limited to, those regarding risk-based capital reports, adjusted risk-based capital reports, risk-based capital plans, corrective orders and procedures to be followed in the event of a triggering of a company action level event, a regulatory action level event, an authorized control level event, or a mandatory control level event.

#### 624.424 Annual statement and other information.—

(8)(a) All authorized insurers must have conducted an annual audit by an independent certified public accountant and must file an audited financial report with the office on or before June 1 for the preceding year ending December 31. The office may require an insurer to file an audited financial report earlier than June 1 upon 90 days' advance notice to the insurer. The office may immediately suspend an insurer's certificate of authority by order if an insurer's failure to file required reports, financial statements, or information required by this subsection or rule adopted pursuant thereto creates a significant uncertainty as to the insurer's continuing eligibility for a certificate of authority.

(b) Any authorized insurer otherwise subject to this section having direct premiums written in this state of less than \$1 million in any calendar year and fewer than 1,000 policyholders or certificateholders of directly written policies nationwide at the end of such calendar year is exempt from this section for such year unless the office makes a specific finding that compliance is necessary in order for the office to carry out its statutory responsibilities. However, any insurer having assumed premiums pursuant to contracts or treaties or reinsurance of \$1 million or more is not exempt. Any insurer subject to an exemption must submit by March 1 following the year to which the exemption applies an affidavit sworn to by a responsible officer of the insurer specifying the amount of direct premiums written in this state and number of policyholders or certificateholders.

(c) The board of directors of an insurer shall hire the certified public accountant that prepares the audit required by this subsection and the board shall establish an audit committee of three or more directors of the insurer or an affiliated company. The audit committee shall be responsible for discussing audit findings and interacting with the certified public accountant with regard to her or his findings. The audit committee shall be comprised of members who are free from any relationship that, in the opinion of its board of directors, would interfere with the exercise of independent judgment as a committee member. The audit committee shall report to the board any findings of adverse financial conditions or significant deficiencies in internal controls that have been noted by the accountant. The insurer may request the office to waive this requirement of the audit committee membership based upon unusual hardship to the insurer.

(d) An insurer may not use the same accountant or partner of an accounting firm responsible for preparing the report required by this subsection for more than 5 consecutive years. Following this period, the insurer may not use such accountant or partner for a period of 5 years, but may use another accountant or partner of the same firm. An insurer may request the office to waive this prohibition based upon an unusual hardship to the insurer and a determination that the accountant is exercising independent judgment that is not unduly influenced by the insurer considering such factors as the number of partners,

expertise of the partners or the number of insurance clients of the accounting firm; the premium volume of the insurer; and the number of jurisdictions in which the insurer transacts business.

(e) The commission shall adopt rules to administer this subsection which must be in substantial conformity with the 2006 Annual Financial Reporting Model Regulation adopted by the NAIC or subsequent amendments, except where inconsistent with the requirements of this subsection. Any exception to, waiver of, or interpretation of accounting requirements of the commission must be in writing and signed by an authorized representative of the office. An insurer may not raise an exception to, waiver of, or interpretation of accounting requirements as a defense in an action, unless previously issued in writing by an authorized representative of the office.

624.324 Hearings.—The department, commission, and office may each hold hearings for any purpose within the scope of this code deemed to be necessary.

**AU-C Section 200*****Overall Objectives of the Independent Auditor  
and the Conduct of an Audit in Accordance  
With Generally Accepted Auditing Standards***

Source: SAS No. 122; SAS No. 123; SAS No. 128; SAS No. 130.

Effective for audits of financial statements for periods ending on or after December 15, 2012.

**Introduction****Scope of This Section**

.01 This section addresses the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with generally accepted auditing standards (GAAS). Specifically, it sets out the overall objectives of the independent auditor (the auditor) and explains the nature and scope of an audit designed to enable the auditor to meet those objectives. It also explains the scope, authority, and structure of GAAS and includes requirements establishing the general responsibilities of the auditor applicable in all engagements conducted in accordance with GAAS, including the obligation to comply with GAAS. [As amended, effective for integrated audits for periods ending on or after December 15, 2016, by SAS No. 130.]

.02 GAAS are developed and issued in the form of Statements on Auditing Standards (SASs) and are codified into AU-C sections. GAAS are written in the context of an audit of financial statements by an auditor. They are to be adapted as necessary in the circumstances when applied to other engagements conducted in accordance with GAAS, such as audits of other historical financial information, compliance audits, and audits of internal control over financial reporting that are integrated with audits of financial statements. GAAS do not address the responsibilities of the auditor that may exist in legislation, regulation, or otherwise, in connection with, for example, the offering of securities to the public. Such responsibilities may differ from those established in GAAS. Accordingly, although the auditor may find aspects of GAAS helpful in such circumstances, it is the responsibility of the auditor to ensure compliance with all relevant legal, regulatory, or professional obligations. [As amended, effective for integrated audits for periods ending on or after December 15, 2016, by SAS No. 130.]

**Association With Financial Statements**

.03 An auditor is associated with financial information when the auditor has applied procedures sufficient to permit the auditor to report in accordance with GAAS. Statements on Standards for Accounting and Review Services address the accountant's considerations when the accountant prepares and presents financial statements to the entity or to third parties.

## An Audit of Financial Statements

**.04** The purpose of an audit is to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework, which enhances the degree of confidence that intended users can place in the financial statements. An audit conducted in accordance with GAAS and relevant ethical requirements enables the auditor to form that opinion. (Ref: par. .A1)

**.05** The financial statements subject to audit are those of the entity, prepared and presented by management of the entity with oversight from those charged with governance. GAAS do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with GAAS is conducted on the premise that management and, when appropriate, those charged with governance have acknowledged certain responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. (Ref: par. .A2–.A13)

**.06** As the basis for the auditor's opinion, GAAS require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high, but not absolute, level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. Reasonable assurance is not an absolute level of assurance because there are inherent limitations of an audit that result in most of the audit evidence, on which the auditor draws conclusions and bases the auditor's opinion, being persuasive rather than conclusive. (Ref: par. .A32–.A56)

**.07** The concept of materiality is applied by the auditor when both planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and uncorrected misstatements, if any, on the financial statements.<sup>1</sup> In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users that are taken based on the financial statements. Judgments about materiality are made in light of surrounding circumstances, and involve both qualitative and quantitative considerations. These judgments are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or both. The auditor's opinion addresses the financial statements as a whole. Therefore, the auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by fraud or error, that are not material to the financial statements as a whole, are detected. (Ref: par. .A14)

**.08** GAAS contain objectives, requirements, and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. GAAS require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things,

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<sup>1</sup> See section 320, *Materiality in Planning and Performing an Audit*, and section 450, *Evaluation of Misstatements Identified During the Audit*.

- identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
- obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- form an opinion on the financial statements, or determine that an opinion cannot be formed, based on an evaluation of the audit evidence obtained.

.09 The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable law or regulation.

.10 The auditor also may have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, regarding matters arising from the audit. These responsibilities may be established by GAAS or by applicable law or regulation.<sup>2</sup>

## Effective Date

.11 This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

## Overall Objectives of the Auditor

.12 The overall objectives of the auditor, in conducting an audit of financial statements, are to

- a. obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework; and
- b. report on the financial statements, and communicate as required by GAAS, in accordance with the auditor's findings.

.13 In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, GAAS require that the auditor disclaim an opinion or withdraw from the engagement, when withdrawal is possible under applicable law or regulation.

## Definitions

.14 For purposes of GAAS, the following terms have the meanings attributed as follows:

**Applicable financial reporting framework.** The financial reporting framework adopted by management and, when appropriate, those charged with governance in the preparation and fair presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

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<sup>2</sup> For examples, see section 260, *The Auditor's Communication With Those Charged With Governance*; section 265, *Communicating Internal Control Related Matters Identified in an Audit*; and paragraph .42 of section 240, *Consideration of Fraud in a Financial Statement Audit*.

**Audit evidence.** Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. *Sufficiency of audit evidence* is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence. *Appropriateness of audit evidence* is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

**Audit risk.** The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

**Auditor.** The term used to refer to the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. When an AU-C section expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term *engagement partner* rather than *auditor* is used. *Engagement partner* and *firm* are to be read as referring to their governmental equivalents when relevant.

**Detection risk.** The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

**Financial reporting framework.** A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements; for example, U.S. generally accepted accounting principles, International Financial Reporting Standards (IFRSs) promulgated by the International Accounting Standards Board (IASB), or a special purpose framework.<sup>3</sup>

The term *fair presentation framework* is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and

- a. acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- b. acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

A financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgments in (a) or (b) is not a fair presentation framework.

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<sup>3</sup> See section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*.



**Financial statements.** A structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources and obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term *financial statements* ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement.

**Historical financial information.** Information expressed in financial terms regarding a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

**Interpretive publications.** Auditing interpretations of GAAS, auditing guidance included in AICPA Audit and Accounting Guides, and AICPA Auditing Statements of Position (SOP).

**Management.** The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance; for example, executive members of a governance board or an owner-manager.

**Misstatement.** A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be presented fairly in accordance with the applicable financial reporting framework. Misstatements can arise from fraud or error.

**Other auditing publications.** Publications other than interpretive publications; these include AICPA auditing publications not defined as interpretive publications; auditing articles in the *Journal of Accountancy* and other professional journals; continuing professional education programs and other instruction materials, textbooks, guide books, audit programs, and checklists; and other auditing publications from state CPA societies, other organizations, and individuals.

**Premise, relating to the responsibilities of management and, when appropriate, those charged with governance, on which an audit is conducted** (the premise). Management and, when appropriate, those charged with governance have acknowledged and understand that they have the following responsibilities that are fundamental to the conduct of an audit in accordance with GAAS; that is, responsibility

- a. for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework;
- b. for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; and
- c. to provide the auditor with

- i. access to all information of which management and, when appropriate, those charged with governance are aware that is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters;
- ii. additional information that the auditor may request from management and, when appropriate, those charged with governance for the purpose of the audit; and
- iii. unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

*The premise, relating to the responsibilities of management and, when appropriate, those charged with governance, on which an audit is conducted may also be referred to as the premise.*

**Professional judgment.** The application of relevant training, knowledge, and experience, within the context provided by auditing, accounting, and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

**Professional skepticism.** An attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence.

**Reasonable assurance.** In the context of an audit of financial statements, a high, but not absolute, level of assurance.

**Risk of material misstatement.** The risk that the financial statements are materially misstated prior to the audit. This consists of two components, described as follows at the assertion level:

**Inherent risk.** The susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

**Control risk.** The risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

**Those charged with governance.** The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel; for example, executive members of a governance board or an owner-manager.

## Requirements

### Ethical Requirements Relating to an Audit of Financial Statements

**.15** The auditor must be independent of the entity when performing an engagement in accordance with GAAS unless (a) GAAS provides otherwise or (b) the auditor is required by law or regulation to accept the engagement and report on the financial statements. When the auditor is not independent and neither (a) nor (b) are applicable, the auditor is precluded from issuing a report under GAAS.

**.16** The auditor should comply with relevant ethical requirements relating to financial statement audit engagements. (Ref: par. .A15–.A21)

### Professional Skepticism

**.17** The auditor should plan and perform an audit with professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated. (Ref: par. .A22–.A26)

### Professional Judgment

**.18** The auditor should exercise professional judgment in planning and performing an audit of financial statements. (Ref: par. .A27–.A31)

### Sufficient Appropriate Audit Evidence and Audit Risk

**.19** To obtain reasonable assurance, the auditor should obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (Ref: par. .A32–.A56)

### Conduct of an Audit in Accordance With GAAS

#### *Complying With AU-C Sections Relevant to the Audit*

**.20** The auditor should comply with all AU-C sections relevant to the audit. An AU-C section is relevant to the audit when the AU-C section is in effect and the circumstances addressed by the AU-C section exist. (Ref: par. .A57–.A62)

**.21** The auditor should have an understanding of the entire text of an AU-C section, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. (Ref: par. .A63–.A71)

**.22** The auditor should not represent compliance with GAAS in the auditor's report unless the auditor has complied with the requirements of this section and all other AU-C sections relevant to the audit.

#### *Objectives Stated in Individual AU-C Sections*

**.23** To achieve the overall objectives of the auditor, the auditor should use the objectives stated in individual AU-C sections in planning and performing the audit considering the interrelationships within GAAS to (Ref: par. .A72–.A74)

- a. determine whether any audit procedures in addition to those required by individual AU-C sections are necessary in pursuance of the objectives stated in each AU-C section; and (Ref: par. .A75)
- b. evaluate whether sufficient appropriate audit evidence has been obtained. (Ref: par. .A76)

### ***Complying With Relevant Requirements***

**.24** Subject to paragraph .26, the auditor should comply with each requirement of an AU-C section unless, in the circumstances of the audit,

- a. the entire AU-C section is not relevant; or
- b. the requirement is not relevant because it is conditional and the condition does not exist. (Ref: par. .A77–.A78)

### ***Defining Professional Responsibilities in GAAS***

**.25** GAAS use the following two categories of professional requirements, identified by specific terms, to describe the degree of responsibility it imposes on auditors:

- Unconditional requirements. The auditor must comply with an unconditional requirement in all cases in which such requirement is relevant. GAAS use the word "must" to indicate an unconditional requirement.
- Presumptively mandatory requirements. The auditor must comply with a presumptively mandatory requirement in all cases in which such a requirement is relevant except in rare circumstances discussed in paragraph .26. GAAS use the word "should" to indicate a presumptively mandatory requirement. (Ref: par. .A79)

**.26** In rare circumstances, the auditor may judge it necessary to depart from a relevant presumptively mandatory requirement. In such circumstances, the auditor should perform alternative audit procedures to achieve the intent of that requirement. The need for the auditor to depart from a relevant presumptively mandatory requirement is expected to arise only when the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the intent of the requirement. (Ref: par. .A80)

### ***Interpretive Publications***

**.27** The auditor should consider applicable interpretive publications in planning and performing the audit. (Ref: par. .A81)

### ***Other Auditing Publications***

**.28** In applying the auditing guidance included in an other auditing publication, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. (Ref: par. .A82–.A84)

### ***Failure to Achieve an Objective***

**.29** If an objective in a relevant AU-C section cannot be achieved, the auditor should evaluate whether this prevents the auditor from achieving the overall objectives of the audit and thereby requires the auditor, in accordance with GAAS, to modify the auditor's opinion or withdraw from the engagement (when withdrawal is possible under applicable law or regulation). Failure to achieve

an objective represents a significant finding or issue requiring documentation in accordance with section 230, *Audit Documentation*.<sup>4</sup> (Ref: par. .A85–.A86)

## Application and Other Explanatory Material

### An Audit of Financial Statements

#### *Scope of the Audit (Ref: par. .04)*

**.A1** The auditor's opinion on the financial statements addresses whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor's opinion, therefore, does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. In some circumstances, however, applicable law or regulation may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control. Although GAAS include requirements and regarding such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

#### *Preparation and Fair Presentation of the Financial Statements (Ref: par. .05)*

**.A2** An audit in accordance with GAAS is conducted on the premise that management and, when appropriate, those charged with governance have acknowledged and understand that they have responsibility

- a. for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework;
- b. for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; and
- c. to provide the auditor with
  - i. access to all information of which management and, when appropriate, those charged with governance are aware that is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters;
  - ii. additional information that the auditor may request from management and, when appropriate, those charged with governance for the purpose of the audit; and
  - iii. unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

**.A3** The preparation and fair presentation of the financial statements by management and, when appropriate, those charged with governance require

- the identification of the applicable financial reporting framework, in the context of any relevant laws or regulations.

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<sup>4</sup> Paragraph .08c of section 230, *Audit Documentation*.

- the preparation and fair presentation of the financial statements in accordance with that framework.
- the inclusion of an adequate description of that framework in the financial statements.

The preparation and fair presentation of the financial statements require management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as in selecting and applying appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

**.A4** The auditor may make suggestions about the form or content of the financial statements, or assist management by preparing them, in whole or in part, based on information provided to the auditor by management during the performance of the audit.\* However, the auditor's responsibility for the audited financial statements is confined to the expression of the auditor's opinion on them.

[Revised, October 2013, to reflect conforming changes necessary due to the revision of Ethics Interpretation No. 101-3.]

**.A5** The financial statements may be prepared in accordance with the following:

- A general purpose framework (a financial reporting framework designed to meet the common financial information needs of a wide range of users); or
- A special purpose framework (a financial reporting framework, other than generally accepted accounting principles, which is a cash, tax, regulatory, contractual basis of accounting, or other basis of accounting; an other basis of accounting uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements).

[Revised, July 2013, to reflect conforming changes necessary due to the issuance of SAS No. 127.]

**.A6** The applicable financial reporting framework often encompasses financial accounting standards promulgated by an authorized or recognized standards-setting organization, or legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial accounting standards promulgated by an authorized or recognized standards-setting organization and legislative or regulatory requirements. Other sources may provide direction on the application of the applicable financial reporting framework. In some cases, the applicable financial reporting framework may encompass such other sources, or may even consist only of such sources. Such other sources may include the following:

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\* In January 2013, the Professional Ethics Executive Committee adopted a provision in the "Scope and Applicability of Nonattest Services" interpretation (ET sec. 1.295.010) under the "Independence Rule" (ET sec. 1.200.001) of the AICPA Code of Professional Conduct. This provision provides, among other things, that financial statement preparation is considered outside the scope of the attest engagement and, therefore, constitutes a nonattest service subject to the requirements of the "Nonattest Services" subtopic (ET sec. 1.295). The provision is effective for engagements covering periods beginning on or after December 15, 2014. [Footnote added, October 2013, to reflect conforming changes necessary due to the revision of Ethics Interpretation No. 101-3. Footnote revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

- The legal and ethical environment, including statutes, regulations, court decisions, and professional ethical obligations regarding accounting matters;
- Published accounting interpretations of varying authority issued by standards-setting, professional, or regulatory organizations;
- Published views of varying authority on emerging accounting issues issued by standards-setting, professional, or regulatory organizations;
- General and industry practices widely recognized and prevalent; and
- Accounting literature.

When conflicts exist between the financial reporting framework and the sources from which direction on its application may be obtained, or among the sources that encompass the financial reporting framework, the source with the highest authority prevails.

**.A7** The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficiently broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

**.A8** The financial accounting standards promulgated by organizations that are authorized or recognized to promulgate standards to be used by entities for preparing financial statements in accordance with a general purpose framework include Financial Accounting Standards Board (FASB) *Accounting Standards Codification*, issued by FASB; IFRSs, issued by the IASB; Statements of Federal Financial Accounting Standards, issued by the Federal Accounting Standards Advisory Board for U.S. federal government entities; and Statements of the Governmental Accounting Standards Board, issued by the Governmental Accounting Standards Board for U.S. state and local governmental entities.

**.A9** The requirements of the applicable financial reporting framework also determine what constitutes a complete set of financial statements. In the case of many frameworks, financial statements are intended to provide information about the financial position, financial performance, and cash flows of an entity. For example, a complete set of financial statements might include a balance sheet, an income statement, a statement of changes in equity, a cash flow statement, and related notes. For some other financial reporting frameworks, a single financial statement and the related notes might constitute a complete set of financial statements. Examples of a single financial statement, each of which would include related notes, include the following:

- Balance sheet
- Statement of income or statement of operations
- Statement of retained earnings
- Statement of cash flows
- Statement of assets and liabilities
- Statement of changes in owners' equity
- Statement of revenue and expenses
- Statement of operations by product lines

**.A10** Section 210, *Terms of Engagement*, establishes requirements and provides guidance on determining the acceptability of the applicable financial reporting framework.<sup>5</sup> Section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, addresses engagements in which the auditor issues a report in connection with financial statements prepared in accordance with a special purpose framework.

**.A11** Because of the significance of the premise to the conduct of an audit, the auditor is required to obtain the agreement of management and, when appropriate, those charged with governance, that they acknowledge and understand that they have the responsibilities set out in paragraph .A2 as a precondition for accepting the audit engagement.<sup>6</sup>

*Considerations Specific to Audits of Governmental Entities*

**.A12** The requirements for audits of the financial statements of governmental entities may be broader than those of other entities. As a result, the premise, relating to management's responsibilities, on which an audit of the financial statements of a governmental entity is conducted, may include additional responsibilities, such as the responsibility for the execution of transactions and events in accordance with law, regulation, or other authority. (See paragraph .A63.)

**.A13** In audits of governmental entities, auditors may have a responsibility under law, regulation, contract, or grant agreement to report to third parties, such as funding agencies or oversight bodies.

**Materiality (Ref: par. .07)**

*Considerations Specific to Audits of Governmental Entities*

**.A14** For most state or local governmental entities, the applicable financial reporting framework is based on multiple reporting units, and therefore requires the presentation of financial statements for its activities in various reporting units. Consequently, a reporting unit, or aggregation of reporting units, of the governmental entity represents an opinion unit to the auditor. Generally, the auditor expresses or disclaims an opinion on a government's financial statements as a whole by expressing an opinion or disclaiming an opinion on each opinion unit. In this context, the auditor is responsible for the detection of misstatements that are material to an opinion unit within a governmental entity, but is not responsible for the detection of misstatements that are not material to an opinion unit.

**Ethical Requirements Relating to an Audit of Financial Statements (Ref: par. .16)**

**.A15** The auditor is subject to relevant ethical requirements relating to financial statement audit engagements. Ethical requirements consist of the AICPA Code of Professional Conduct together with rules of state boards of accountancy and applicable regulatory agencies that are more restrictive.

**.A16** The AICPA Code of Professional Conduct establishes the fundamental principles of professional ethics, which include the following:

- Responsibilities
- The public interest

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<sup>5</sup> Paragraph .06a of section 210, *Terms of Engagement*.

<sup>6</sup> Paragraph .06b of section 210.



- Integrity
- Objectivity and independence
- Due care
- Scope and nature of services

**.A17** In the case of an audit engagement, it is in the public interest and, therefore, required by this section, that the auditor be independent of the entity subject to the audit. The concept of independence refers to both independence in fact and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective, and to maintain an attitude of professional skepticism. Independence implies an impartiality that recognizes an obligation to be fair not only to management and those charged with governance of an entity but also users of the financial statements who may rely upon the independent auditor's report. Guidance on threats to independence is set forth in the AICPA's "Conceptual Framework for Independence" (ET sec. 1.210.010). [Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

**.A18** When the auditor is not independent but is required by law or regulation to report on the financial statements, section 705, *Modifications to the Opinion in the Independent Auditor's Report*, applies.

**.A19** Due care requires the auditor to discharge professional responsibilities with competence and to have the appropriate capabilities to perform the audit and enable an appropriate auditor's report to be issued.

**.A20** QC section 10, *A Firm's System of Quality Control*, sets out the firm's responsibilities to establish and maintain its system of quality control for audit engagements, and to establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements, including those pertaining to independence.<sup>7</sup> Section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, addresses the engagement partner's responsibilities regarding relevant ethical requirements. These include remaining alert for evidence of noncompliance with relevant ethical requirements by members of the engagement team, determining, in consultation with others in the firm as appropriate, the appropriate action if matters come to the engagement partner's attention, through the firm's system of quality control or otherwise, that indicate that members of the engagement team have not complied with relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit engagement.<sup>8</sup> Section 220 recognizes that the engagement team is entitled to rely on a firm's system of quality control in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless the engagement partner determines that it is inappropriate to do so based on information provided by the firm or other parties.

### **Considerations Specific to Audits of Governmental Entities**

**.A21** In addition to the AICPA Code of Professional Conduct and GAAS, *Government Auditing Standards*, which may be required by law, regulation,

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<sup>7</sup> Paragraphs .21–.25 of QC section 10, *A Firm's System of Quality Control*.

<sup>8</sup> Paragraphs .11–.13 of section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*.

contract, or grant agreement in audits of governmental entities and entities that receive government awards, set forth relevant ethical principles and auditing standards, including standards on auditor independence, professional judgment, competence, and audit quality control and assurance.

### Professional Skepticism (Ref: par. .17)

**.A22** Professional skepticism includes being alert to the following, for example,

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by GAAS.

**.A23** Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of

- overlooking unusual circumstances.
- over-generalizing when drawing conclusions from audit observations.
- using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

**.A24** Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in light of the circumstances; for example, in the case when fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

**.A25** The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence.<sup>9</sup> In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), GAAS require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.<sup>10</sup>

**.A26** The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be

<sup>9</sup> Paragraphs .07–.09 of section 500, *Audit Evidence*.

<sup>10</sup> Paragraph .10 of section 500 and paragraphs .10–.11 and .16 of section 505, *External Confirmations*.

satisfied with less than persuasive audit evidence when obtaining reasonable assurance.

### Professional Judgment (Ref: par. .18)

**.A27** Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and GAAS and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. In particular, professional judgment is necessary regarding decisions about the following:

- Materiality and audit risk
- The nature, timing, and extent of audit procedures used to meet the requirements of GAAS and gather audit evidence
- Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of GAAS and thereby, the overall objectives of the auditor
- The evaluation of management's judgments in applying the entity's applicable financial reporting framework
- The drawing of conclusions based on the audit evidence obtained; for example, assessing the reasonableness of the estimates made by management in preparing the financial statements

**.A28** The distinguishing feature of professional judgment expected of an auditor is that such judgment is exercised based on competencies necessary to achieve reasonable judgments, developed by the auditor through relevant training, knowledge, and experience.

**.A29** The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as those required by section 220, assists the auditor in making informed and reasonable judgments.<sup>11</sup>

**.A30** Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing standards and accounting principles and is appropriate in light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report.

**.A31** Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant findings or issues arising during the audit.<sup>12</sup> Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or by sufficient appropriate audit evidence.

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<sup>11</sup> Paragraph .20 of section 220.

<sup>12</sup> Paragraph .08 of section 230.

## Sufficient Appropriate Audit Evidence and Audit Risk (Ref: par. .19)

### *Sufficiency and Appropriateness of Audit Evidence*

**.A32** Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit<sup>13</sup>) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by a specialist employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management's assertions and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and, therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

**.A33** The sufficiency and appropriateness of audit evidence are interrelated. *Sufficiency* is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

**.A34** *Appropriateness* is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

**.A35** Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby to enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. Section 500, *Audit Evidence*, and other relevant AU-C sections, establish additional requirements and provide further guidance applicable throughout the audit regarding the auditor's considerations in obtaining sufficient appropriate audit evidence.

### **Audit Risk**

**.A36** Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

**.A37** For purposes of GAAS, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit

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<sup>13</sup> Paragraph .10 of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks, such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

*Risks of Material Misstatement*

**.A38** The risks of material misstatement exist at two levels:

- The overall financial statement level
- The assertion level for classes of transactions, account balances, and disclosures

**.A39** Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

**.A40** Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. Auditors use various approaches to accomplish the objective of assessing the risks of material misstatement. For example, the auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an acceptable level of detection risk. Some auditors find such a model to be useful when planning audit procedures.

**.A41** The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

**.A42** Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.

**.A43** Control risk is a function of the effectiveness of the design, implementation, and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation and fair presentation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. GAAS provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness

of controls in determining the nature, timing, and extent of substantive procedures to be performed.<sup>14</sup>

**.A44** GAAS do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the risks of material misstatement. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages or in nonquantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

**.A45** Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

#### *Detection Risk*

**.A46** For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

**.A47** Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. The following matters assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results:

- Adequate planning
- Proper assignment of personnel to the engagement team
- The application of professional skepticism
- Supervision and review of the audit work performed

**.A48** Section 300, *Planning an Audit*, and section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, establish requirements and provide guidance on planning an audit of financial statements and the auditor's responses to assessed risks. Detection risk, however, can only be reduced, not eliminated, because of the inherent limitations of an audit. Accordingly, some detection risk will always exist.

#### *Inherent Limitations of an Audit*

**.A49** The auditor is not expected to, and cannot, reduce audit risk to zero and cannot, therefore, obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because inherent limitations of an audit exist, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The principal inherent limitations of an audit arise from

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<sup>14</sup> Paragraph .08 of section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

- the nature of financial reporting;
- the nature of audit procedures; and
- the need for the audit to be conducted within a reasonable period of time and so as to achieve a balance between benefit and cost.

*The Nature of Financial Reporting*

**.A50** The preparation and fair presentation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and a range exists of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability that cannot be eliminated by the application of additional auditing procedures. For example, this is often the case with respect to certain accounting estimates that are dependent on predictions of future events. Nevertheless, GAAS require the auditor to give specific consideration to whether accounting estimates are reasonable in the context of the applicable financial reporting framework and to related disclosures, and to the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.<sup>15</sup>

*The Nature of Audit Procedures*

**.A51** There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

- There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and fair presentation of the financial statements or that has been requested by the auditor. Accordingly, the auditor cannot be certain of the completeness of information, even though the auditor has performed audit procedures to obtain assurance that all relevant information has been obtained.
- Fraud may involve sophisticated and carefully organized schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation that may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
- An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

*Timeliness of Financial Reporting and the Balance Between Benefit and Cost*

**.A52** The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be

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<sup>15</sup> See section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, and section 700, *Forming an Opinion and Reporting on Financial Statements*.

struck between the reliability of information and its cost. This is recognized in certain financial reporting frameworks (see, for example, FASB's Statements of Financial Accounting Concepts). Therefore, there is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and so as to achieve a balance between benefit and cost, recognizing that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is fraudulent or erroneous until proved otherwise.

**.A53** Consequently, it is necessary for the auditor to

- plan the audit so that it will be performed in an effective manner;
- direct audit effort to areas most expected to contain risks of material misstatement, whether due to fraud or error, with correspondingly less effort directed at other areas; and
- use testing and other means of examining populations for misstatements.

**.A54** In light of the approaches described in paragraph .A53, GAAS contain requirements for the planning and performance of the audit and requires the auditor, among other things, to

- have a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels by performing risk assessment procedures and related activities;<sup>16</sup> and
- use testing and other means of examining populations in a manner that provides a reasonable basis for the auditor to draw conclusions about the population.<sup>17</sup>

#### *Other Matters That Affect the Inherent Limitations of an Audit*

**.A55** In the case of certain assertions or subject matters, the potential effects of the inherent limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include the following:

- Fraud, particularly fraud involving senior management or collusion. See section 240, *Consideration of Fraud in a Financial Statement Audit*, for further discussion.
- The existence and completeness of related party relationships and transactions. See section 550, *Related Parties*, for further discussion.
- The occurrence of noncompliance with laws and regulations. See section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, for further discussion.
- Future events or conditions that may cause an entity to cease to continue as a going concern. See section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

Relevant AU-C sections identify specific audit procedures to assist in lessening the effect of the inherent limitations. [Revised, August 2012, to reflect conforming changes necessary due to the issuance of SAS No. 126.]

<sup>16</sup> See section 315.

<sup>17</sup> See section 330, section 500, section 520, *Analytical Procedures*, and section 530, *Audit Sampling*.



**.A56** Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with GAAS. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with GAAS. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less than persuasive audit evidence. Whether the auditor has performed an audit in accordance with GAAS is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof, and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.

## Conduct of an Audit in Accordance With GAAS

### *Nature of GAAS (Ref: par. .20)*

**.A57** The "Compliance With Standards Rule" (ET sec. 1.310.001) of the AICPA Code of Professional Conduct requires an AICPA member who performs an audit to comply with standards promulgated by the Auditing Standards Board (ASB). The ASB develops and issues standards in the form of SASs through a process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs are codified in AU-C sections. [Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

**.A58** GAAS provide the standards for the auditor's work in fulfilling the overall objectives of the auditor. GAAS address the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific topics.

**.A59** The scope, effective date, and any specific limitation of the applicability of a specific AU-C section are made clear in the AU-C section. Unless otherwise stated in the AU-C section, the auditor is permitted to apply an AU-C section before the effective date specified therein.

**.A60** In certain audit engagements, the auditor also may be required to comply with other auditing requirements in addition to GAAS. GAAS do not override law or regulation that governs an audit of financial statements. In the event that such law or regulation differs from GAAS, an audit conducted only in accordance with law or regulation will not necessarily comply with GAAS.

**.A61** The auditor may also conduct the audit in accordance with both GAAS and

- auditing standards promulgated by the Public Company Accounting Oversight Board,
- International Standards on Auditing,
- *Government Auditing Standards*, or
- auditing standards of a specific jurisdiction or country.

In such cases, in addition to complying with each of the AU-C sections relevant to the audit, it may be necessary for the auditor to perform additional audit procedures in order to comply with the other auditing standards.

*Considerations Specific to Audits of Governmental Entities*

**.A62** GAAS are relevant to financial statement audits of governmental entities. The auditor's responsibilities, however, may be affected by law, regulation, or other authority (such as government policy requirements or resolutions of the legislature), which may encompass a broader scope than an audit of financial statements in accordance with GAAS. These additional responsibilities are not addressed in GAAS. *Government Auditing Standards* are relevant for engagements to audit U.S. government entities, and when required by law, regulation, contract, or grant agreement. The appendix to *Government Auditing Standards* includes a listing of some of the laws, regulations, and guidelines that require use of *Government Auditing Standards*.

**Contents of GAAS (Ref: par. .21)**

**.A63** In addition to objectives and requirements, an AU-C section contains related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context relevant to a proper understanding of the AU-C section and definitions. The entire text of an AU-C section, therefore, is relevant to an understanding of the objectives stated in an AU-C section and the proper application of the requirements of an AU-C section.

**.A64** When necessary, the application and other explanatory material provides further explanation of the requirements of an AU-C section and guidance for carrying them out. In particular, it may

- explain more precisely what a requirement means or is intended to cover.
- include examples of procedures that may be appropriate in the circumstances.

Although such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU-C section. The auditor is required by paragraph .21 to understand the application and other explanatory material; how the auditor applies the guidance in the engagement depends on the exercise of professional judgment in the circumstances consistent with the objective of the AU-C section. The words "may," "might," and "could" are used to describe these actions and procedures. The application and other explanatory material may also provide background information on matters addressed in an AU-C section.

**.A65** Appendixes form part of the application and other explanatory material. The purpose and intended use of an appendix are explained in the body of the related AU-C section or within the title and introduction of the appendix itself.

**.A66** Introductory material may include, as needed, such matters as explanation of the following:

- The purpose and scope of the AU-C section, including how the AU-C section relates to other AU-C sections.
- The subject matter of the AU-C section.
- The respective responsibilities of the auditor and others regarding the subject matter of the AU-C section.
- The context in which the AU-C section is set.

**.A67** An AU-C section may include, in a separate section under the heading "Definitions," a description of the meanings attributed to certain terms for purposes of GAAS. These are provided to assist in the consistent application

and interpretation of GAAS, and are not intended to override definitions that may be established for other purposes, whether in law, regulation, or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout GAAS.

**.A68** When appropriate, additional considerations specific to audits of smaller, less complex entities and governmental entities are included within the application and other explanatory material of an AU-C section. These additional considerations assist in the application of the requirements of GAAS in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of GAAS.

*Considerations Specific to Audits of Smaller, Less Complex Entities*

**.A69** For purposes of specifying additional considerations to audits of smaller, less complex entities, a *smaller, less complex entity* refers to an entity that typically possesses qualitative characteristics, such as the following:

- a. Concentration of ownership and management in a small number of individuals; and
- b. One or more of the following:
  - i. Straightforward or uncomplicated transactions
  - ii. Simple record keeping
  - iii. Few lines of business and few products within business lines
  - iv. Few internal controls
  - v. Few levels of management with responsibility for a broad range of controls
  - vi. Few personnel, many having a wide range of duties

These qualitative characteristics are not exhaustive, they are not exclusive to smaller, less complex entities, and smaller, less complex entities do not necessarily display all of these characteristics.

**.A70** GAAS refer to the proprietor of a smaller entity who is involved in running the entity on a day-to-day basis as the *owner-manager*.

*Considerations Specific to Governmental Entities*

**.A71** Considerations specific to governmental entities may also be applicable to nongovernmental entities that receive government awards. In audits of governmental entities, the considerations specific to audits of smaller, less complex entities may not apply, even if the governmental entity has few employees, simple operations, or a relatively small budget, because small governmental entities (1) may have complex transactions with federal and state governments, (2) are required to comply with laws, regulations, policies, and systems determined by a higher level of government, and (3) are subject to additional public expectations of accountability and transparency.

**Objectives Stated in Individual AU-C Sections (Ref: par. .23)**

**.A72** Each AU-C section contains one or more objectives that provide a link between the requirements and the overall objectives of the auditor. The objectives in individual AU-C sections serve to focus the auditor on the desired outcome of the AU-C section, while being specific enough to assist the auditor in

- understanding what needs to be accomplished and, when necessary, the appropriate means of doing so; and

- deciding whether more needs to be done to achieve the objectives in the particular circumstances of the audit.

**.A73** Objectives are to be understood in the context of the overall objectives of the auditor stated in paragraph .12. As with the overall objectives of the auditor, the ability to achieve an individual objective is equally subject to the inherent limitations of an audit.

**.A74** In using the objectives, the auditor is required to consider the interrelationships among the AU-C sections. This is because, as indicated in paragraph .A58, the AU-C sections in some cases address general responsibilities and in others address the application of those responsibilities to specific topics. For example, this section requires the auditor to adopt an attitude of professional skepticism; this is necessary in all aspects of planning and performing an audit but is not repeated as a requirement of each AU-C section. At a more detailed level, section 315 and section 330 contain, among other things, objectives and requirements that address the auditor's responsibilities to identify and assess the risks of material misstatement and to design and perform further audit procedures to respond to those assessed risks, respectively; these objectives and requirements apply throughout the audit. An AU-C section addressing specific aspects of the audit may expand on how the objectives and requirements of other AU-C sections are to be applied regarding the subject of that AU-C section, but does not repeat those objectives and requirements. For example, section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures*, expands on how the objectives and requirements of section 315 and section 330 are to be applied regarding the subject of section 540, but section 540 does not repeat those objectives and requirements. Thus, in achieving the objective stated in section 540, the auditor considers the objectives and requirements of other relevant AU-C sections.

*Use of Objectives to Determine Need for Additional Audit Procedures (Ref: par. .23a)*

**.A75** The requirements of GAAS are designed to enable the auditor to achieve the objectives specified in GAAS, and thereby the overall objectives of the auditor. The proper application of the requirements of GAAS by the auditor is therefore expected to provide a sufficient basis for the auditor's achievement of the objectives. However, because the circumstances of audit engagements vary widely and all such circumstances cannot be anticipated in GAAS, the auditor is responsible for determining the audit procedures necessary to fulfill the requirements of GAAS and to achieve the objectives. In the circumstances of an engagement, there may be particular matters that require the auditor to perform audit procedures in addition to those required by GAAS to meet the objectives specified in GAAS.

*Use of Objectives to Evaluate Whether Sufficient Appropriate Audit Evidence Has Been Obtained (Ref: par. .23b)*

**.A76** The auditor is required by paragraph .23b to use the objectives stated in the relevant AU-C sections to evaluate whether sufficient appropriate audit evidence has been obtained in the context of the overall objectives of the auditor. If, as a result, the auditor concludes that the audit evidence is not sufficient and appropriate, then the auditor may follow one or more of the following approaches to meeting the requirement of paragraph .23b:

- Evaluate whether further relevant audit evidence has been, or will be, obtained as a result of complying with other AU-C sections
- Extend the work performed in applying one or more requirements

- Perform other procedures judged by the auditor to be necessary in the circumstances

When none of the preceding is expected to be practical or possible in the circumstances, the auditor will not be able to obtain sufficient appropriate audit evidence and is required by GAAS to determine the effect on the auditor's report or on the auditor's ability to complete the engagement.

### **Complying With Relevant Requirements**

#### *Relevant Requirements (Ref: par. .24)*

**.A77** In some cases, an AU-C section (and therefore all of its requirements) may not be relevant in the circumstances. For example, if an entity does not have an internal audit function, nothing in section 610, *Using the Work of Internal Auditors*, is relevant. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

**.A78** Within a relevant AU-C section, there may be conditional requirements. Such a requirement is relevant when the circumstances envisioned in the requirement apply and the condition exists. In general, the conditionality of a requirement will either be explicit or implicit, for example:

- The requirement to modify the auditor's opinion if there is a limitation of scope<sup>18</sup> represents an explicit conditional requirement.
- The requirement to communicate significant deficiencies and material weaknesses in internal control identified during the audit to management and those charged with governance,<sup>19</sup> which depends on the existence and identification of such deficiencies, represents an implicit conditional requirement.

In some cases, a requirement may be expressed as being conditional on applicable law or regulation. For example, the auditor may be required to withdraw from the audit engagement, when withdrawal is possible under applicable law or regulation, or the auditor may be required to perform a certain action, unless prohibited by law or regulation. Depending on the jurisdiction, the legal or regulatory permission or prohibition may be explicit or implicit.

#### *Presumptively Mandatory Requirements (Ref: par. .25)*

**.A79** If an AU-C section provides that a procedure or action is one that the auditor *should consider*, consideration of the procedure or action is presumptively required. Whether the auditor performs the procedure or action is based upon the outcome of the auditor's consideration and the auditor's professional judgment.

#### *Departure From a Requirement (Ref: par. .26)*

**.A80** Section 230 establishes documentation requirements in those exceptional circumstances when the auditor departs from a relevant requirement.<sup>20</sup> GAAS do not call for compliance with a requirement that is not relevant in the circumstances of the audit.

### **Interpretive Publications (Ref: par. .27)**

**.A81** Interpretive publications are not auditing standards. *Interpretive publications* are recommendations on the application of GAAS in specific circumstances, including engagements for entities in specialized industries. An

<sup>18</sup> See section 705, *Modifications to the Opinion in the Independent Auditor's Report*.

<sup>19</sup> Paragraph .11 of section 265.

<sup>20</sup> Paragraph .13 of section 230.

interpretive publication is issued under the authority of the ASB after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. Auditing interpretations of GAAS are included in AU-C sections. AICPA Audit and Accounting Guides and auditing SOPs are listed in AU-C appendix D, *AICPA Audit and Accounting Guides and Statements of Position*.

**Other Auditing Publications (Ref: par. .28)**

**.A82** Other auditing publications have no authoritative status; however, they may help the auditor understand and apply GAAS. The auditor is not expected to be aware of the full body of other auditing publications.

**.A83** Although the auditor determines the relevance of these publications in accordance with paragraph .28, the auditor may presume that other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are appropriate. These other auditing publications are listed in AU-C appendix F, *Other Auditing Publications*.

**.A84** In determining whether an other auditing publication that has not been reviewed by the AICPA Audit and Attest Standards staff is appropriate to the circumstances of the audit, the auditor may consider the degree to which the publication is recognized as being helpful in understanding and applying GAAS and the degree to which the publisher or author is recognized as an authority in auditing matters. [Revised, February 2017, to better reflect the AICPA Council Resolution designating the PCAOB to promulgate technical standards.]

**Failure to Achieve an Objective (Ref: par. .29)**

**.A85** Whether an objective has been achieved is a matter for the auditor's professional judgment. That judgment takes account of the results of audit procedures performed in complying with the requirements of GAAS, and the auditor's evaluation of whether sufficient appropriate audit evidence has been obtained and whether more needs to be done in the particular circumstances of the audit to achieve the objectives stated in GAAS. Accordingly, circumstances that may give rise to a failure to achieve an objective include those that

- prevent the auditor from complying with the relevant requirements of an AU-C section.
- result in it not being practicable or possible for the auditor to carry out the additional audit procedures or obtain further audit evidence as determined necessary from the use of the objectives in accordance with paragraph .23; for example, due to a limitation in the available audit evidence.

**.A86** Audit documentation that meets the requirements of section 230 and the specific documentation requirements of other relevant AU-C sections provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor. Although it is unnecessary for the auditor to document separately (as in a checklist, for example) that individual objectives have been achieved, the documentation of a failure to achieve an objective assists the auditor's evaluation of whether such a failure has prevented the auditor from achieving the overall objectives of the auditor.

**AU-C Section 265*****Communicating Internal Control Related Matters Identified in an Audit***

Source: SAS No. 122; SAS No. 125; SAS No. 128; SAS No. 130.

See section 9265 for interpretations of this section.

Effective for audits of financial statements for periods ending on or after December 15, 2012.

**Introduction****Scope of This Section**

.01 This section addresses the auditor's responsibility to appropriately communicate to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements. This section does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control or designing and performing tests of controls over and above the requirements of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. Section 260, *The Auditor's Communication With Those Charged With Governance*, establishes further requirements and provides guidance regarding the auditor's responsibility to communicate with those charged with governance regarding the audit.

.02 The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement.<sup>1</sup> In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. This section specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.

.03 Nothing in this section precludes the auditor from communicating to those charged with governance or management other internal control matters that the auditor has identified during the audit.

.04 This section is not applicable if the auditor is engaged to perform an audit of internal control over financial reporting that is integrated with an audit of financial statements. In such circumstances, section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements*, applies. [As amended, effective for integrated audits for periods ending on or after December 15, 2016, by SAS No. 130. Revised, December 2016, to reflect conforming changes necessary to reflect the issuance of SAS No. 130.]

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<sup>1</sup> Paragraph .13 of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Paragraphs .A61–.A67 of section 315 provide guidance on obtaining an understanding of internal control relevant to the audit.

### Effective Date

.05 This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

### Objective

.06 The objective of the auditor is to appropriately communicate to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

### Definitions

.07 For purposes of generally accepted auditing standards, the following terms have the meanings attributed as follows:

**Deficiency in internal control.** A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing, or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in *operation* exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

**Material weakness.** A deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probably as defined as follows:

**Reasonably possible.** The chance of the future event or events occurring is more than remote but less than likely.

**Probable.** The future event or events are likely to occur.

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

[As amended, effective for integrated audits for periods ending on or after December 15, 2016, by SAS No. 130.]

### Requirements

#### Determination of Whether Deficiencies in Internal Control Have Been Identified

.08 The auditor should determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. (Ref: par. .A1–.A4)



## Evaluating Identified Deficiencies in Internal Control (Ref: par. .A5–.A14)

**.09** If the auditor has identified one or more deficiencies in internal control, the auditor should evaluate each deficiency to determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies or material weaknesses.

**.10** If the auditor initially determines that a deficiency, or a combination of deficiencies, in internal control is not a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion. [As amended, effective for integrated audits for periods ending on or after December 15, 2016, by SAS No. 130.]

## Communication of Deficiencies in Internal Control

**.11** The auditor should communicate in writing to those charged with governance on a timely basis significant deficiencies and material weaknesses identified during the audit, including those that were remediated during the audit. (Ref: par. .A15–.A20 and .A28)

**.12** The auditor also should communicate to management at an appropriate level of responsibility, on a timely basis (Ref: par. .A21 and .A28)

- a. in writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances. (Ref: par. .A16 and .A22–.A23)
- b. in writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication. (Ref: par. .A24–.A27)

**.13** The communications referred to in paragraphs .11–.12 should be made no later than 60 days following the report release date. (Ref: par. .A16–.A17)

**.14** The auditor should include in the auditor's written communication of significant deficiencies and material weaknesses (Ref: par. .A29–.A33)

- a. the definition of the term *material weakness* and, when relevant, the definition of the term *significant deficiency*.
- b. a description of the significant deficiencies and material weaknesses and an explanation of their potential effects. (Ref: par. .A29)
- c. sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor should include in the communication the following elements that explain that (Ref: par. .A30–.A31)
  - i. the purpose of the audit was for the auditor to express an opinion on the financial statements.
  - ii. the audit included consideration of internal control over financial reporting in order to design audit procedures that are appropriate in the circumstances but not for the

purpose of expressing an opinion on the effectiveness of internal control.

- iii. the auditor is not expressing an opinion on the effectiveness of internal control.
  - iv. the auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified.
- d. an appropriate alert, in accordance with section 905, *Alert That Restricts the Use of the Auditor's Written Communication*.<sup>2</sup> (Ref: par. A32)

[As amended, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125.]

**.15** When the auditor issues a written communication stating that no material weaknesses were identified during the audit, the communication should include the matters in paragraph .14a and c–d. (Ref: par. A34–A36)

**.16** The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit. (Ref: par. A34)

## Application and Other Explanatory Material

### Determination of Whether Deficiencies in Internal Control Have Been Identified (Ref: par. .08)

**.A1** In determining whether the auditor has identified one or more deficiencies in internal control, the auditor may discuss the relevant facts and circumstances of the auditor's findings with the appropriate level of management. This discussion provides an opportunity for the auditor to alert management on a timely basis to the existence of deficiencies of which management may not have been previously aware. The level of management with whom it is appropriate to discuss the findings is one that is familiar with the internal control area concerned and that has the authority to take remedial action on any identified deficiencies in internal control. In some circumstances, it may not be appropriate for the auditor to discuss the auditor's findings directly with management (for example, if the findings appear to call management's integrity or competence into question [see paragraph .A22]).

**.A2** In discussing the facts and circumstances of the auditor's findings with management, the auditor may obtain other relevant information for further consideration, such as

- management's understanding of the actual or suspected causes of the deficiencies.
- exceptions arising from the deficiencies that management may have noted (for example, misstatements that were not prevented by the relevant IT controls).
- a preliminary indication from management of its response to the findings.

<sup>2</sup> Paragraphs .06c, .07, and .11 of section 905, *Alert That Restricts the Use of the Auditor's Written Communication*. [Footnote added, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125.]

**Considerations Specific to Smaller, Less Complex Entities**

**.A3** Although the concepts underlying control activities in smaller entities are likely to be similar to those in larger entities, the formality with which controls operate will vary. Further, smaller entities may find that certain types of control activities are not necessary because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide effective control over important account balances and transactions, lessening or removing the need for more detailed control activities.

**.A4** Also, smaller entities often have fewer employees, which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. On the other hand, such increased management oversight also may increase the risk of management override of controls.

**Evaluating Identified Deficiencies in Internal Control  
(Ref: par. .09–.10)**

**.A5** The severity of a deficiency, or a combination of deficiencies, in internal control depends not only on whether a misstatement has actually occurred but also on

- the magnitude of the potential misstatement resulting from the deficiency or deficiencies and
- whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct, a misstatement of an account balance or disclosure.

Significant deficiencies and material weaknesses may exist even though the auditor has not identified misstatements during the audit. [As amended, effective for integrated audits for periods ending on or after December 15, 2016, by SAS No. 130.]

**.A6** Factors that affect the magnitude of a misstatement that might result from a deficiency, or deficiencies, in internal control include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency
- The volume of activity (in the current period or expected in future periods) in the class of transactions or account balance exposed to the deficiency

[As amended, effective for integrated audits for periods ending on or after December 15, 2016, by SAS No. 130.]

**.A7** In evaluating the magnitude of the potential misstatement, the maximum amount by which an account balance or total of transactions can be overstated generally is the recorded amount, whereas understatements could be larger.

**.A8** Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, in internal control will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

- The nature of the financial statement classes of transactions, account balances, disclosures, and assertions involved

- The cause and frequency of the exceptions detected as a result of the deficiency, or deficiencies, in internal control
- The susceptibility of the related asset or liability to loss or fraud
- The subjectivity, complexity, or extent of judgment required to determine the amount involved
- The interaction or relationship of the control(s) with other controls
- The interaction with other deficiencies in internal control
- The possible future consequences of the deficiency, or deficiencies, in internal control
- The importance of the controls, such as the following, to the financial reporting process:
  - general monitoring controls (such as oversight of management)
  - controls over the prevention and detection of fraud
  - controls over the selection and application of significant accounting policies
  - controls over significant transactions with related parties
  - controls over significant transactions outside the entity's normal course of business
  - controls over the period-end financial reporting process (such as controls over nonrecurring journal entries)

[As amended, effective for integrated audits for periods ending on or after December 15, 2016, by SAS No. 130.]

**.A9** The evaluation of whether a deficiency in internal control presents a reasonable possibility of misstatement may be made without quantifying the probability of occurrence as a specific percentage or range. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

**.A10** Controls may be designed to operate individually, or in combination, to effectively prevent, or detect and correct, misstatements.<sup>3</sup> For example, controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the account balance. A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency or a material weakness. However, a combination of deficiencies affecting the same class of transactions, account balance, or disclosure, relevant assertion, or component of internal control may increase the risks of misstatement to such an extent to give rise to a significant deficiency or material weakness. [As amended, effective for integrated audits for periods ending on or after December 15, 2016, by SAS No. 130.]

**.A11** Indicators of material weaknesses in internal control include

- identification of fraud, whether or not material, on the part of senior management. For the purpose of this indicator, the term "senior management" includes the principal executive and financial officers as well as any other members of senior management who play a significant role in the entity's financial reporting process;

<sup>3</sup> Paragraph .A68 of section 315. [Footnote renumbered by the issuance of SAS No. 125, December 2011.]

- restatement of previously issued financial statements to reflect the correction of a material misstatement due to fraud or error;
- identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected and corrected by the entity's internal control; and
- ineffective oversight of the entity's financial reporting and internal control by those charged with governance.

[As amended, effective for integrated audits for periods ending on or after December 15, 2016, by SAS No. 130.]

### ***Considerations Specific to Governmental Entities***

**.A12** Law or regulation may require the auditor to communicate to those charged with governance or other relevant parties (such as regulators) deficiencies in internal control that the auditor has identified during the audit using specific terms and definitions that differ from those in this section. In such circumstances, the auditor uses such terms and definitions when communicating deficiencies in internal control in accordance with the requirements of the law or regulation and in accordance with this section.

**.A13** When law or regulation requires the auditor to communicate deficiencies in internal control that the auditor has identified during the audit using specific terms, but such terms have not been defined, the auditor may use the definitions, requirements, and guidance in this section to comply with the law or regulation.

**.A14** The requirements of this section remain applicable, notwithstanding that law or regulation may require the auditor to use specific terms or definitions.

## **Communication of Deficiencies in Internal Control (Ref: par. .11–.16)**

### ***Communication of Significant Deficiencies and Material Weaknesses to Those Charged With Governance (Ref: par. .11)***

**.A15** Communicating significant deficiencies and material weaknesses in writing to those charged with governance reflects the importance of these matters and assists those charged with governance in fulfilling their oversight responsibilities. Section 260 establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.<sup>4</sup>

**.A16** Although the auditor is required by paragraph .13 to make the communications referred to in paragraphs .11–.12 no later than 60 days following the report release date, the communication is best made by the report release date because receipt of such communication may be an important factor in enabling those charged with governance to discharge their oversight responsibilities. Nevertheless, because the auditor's written communication of significant deficiencies and material weaknesses forms part of the final audit file, the written communication is subject to the overriding requirement for the auditor to

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<sup>4</sup> Paragraph .09 of section 260, *The Auditor's Communication With Those Charged With Governance*. [Footnote renumbered by the issuance of SAS No. 125, December 2011.]

complete the assembly of the final audit file on a timely basis, no later than 60 days following the report release date.<sup>5</sup>

**.A17** Early communication to those charged with governance or management may be important for some matters because of their relative significance and the urgency for corrective follow-up action. Regardless of the timing of the written communication of significant deficiencies and material weaknesses, the auditor may communicate these orally in the first instance to management and, when appropriate, those charged with governance to assist them in taking timely remedial action to minimize the risks of material misstatement. However, oral communication does not relieve the auditor of the responsibility to communicate the significant deficiencies and material weaknesses in writing, as this section requires.

**.A18** The level of detail at which to communicate significant deficiencies and material weaknesses is a matter of the auditor's professional judgment in the circumstances. Factors that the auditor may consider in determining an appropriate level of detail for the communication include, for example, the following:

- The nature of the entity. For example, the communication required for a governmental entity may be different from that for a non-governmental entity.
- The size and complexity of the entity. For example, the communication required for a complex entity may be different from that for an entity operating a simple business.
- The nature of significant deficiencies and material weaknesses that the auditor has identified.
- The entity's governance composition. For example, more detail may be needed if those charged with governance include members who do not have significant experience in the entity's industry or in the affected areas.
- Legal or regulatory requirements regarding the communication of specific types of deficiencies in internal control.

**.A19** Management and those charged with governance may already be aware of significant deficiencies and material weaknesses that the auditor has identified during the audit and may have chosen not to remedy them because of cost or other considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management and those charged with governance. Accordingly, the requirements to communicate significant deficiencies and material weaknesses in paragraphs .11–.12 apply, regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.

**.A20** The fact that the auditor communicated a significant deficiency or material weakness to those charged with governance and management in a previous audit does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. If a previously communicated significant deficiency or material weakness remains, the current year's communication may repeat the description from the previous communication or simply reference the previous communication and the date of that communication. The auditor may ask management or, when appropriate, those charged

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<sup>5</sup> Paragraph .16 of section 230, *Audit Documentation*. [Footnote renumbered by the issuance of SAS No. 125, December 2011.]

with governance why the significant deficiency or material weakness has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency or material weakness.

***Communication of Deficiencies in Internal Control to Management***  
**(Ref: par. .12)**

**.A21** Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the deficiencies in internal control and to take the necessary remedial action. For significant deficiencies and material weaknesses, the appropriate level is likely to be the CEO or CFO (or equivalent) because these matters also are required to be communicated to those charged with governance. For other deficiencies in internal control, the appropriate level may be operational management with more direct involvement in the control areas affected and with the authority to take appropriate remedial action.

***Communication of Significant Deficiencies and Material Weaknesses in Internal Control to Management*** (Ref: par. .12a)

**.A22** Certain identified significant deficiencies or material weaknesses in internal control may call into question the integrity or competence of management. For example, there may be evidence of fraud or intentional noncompliance with laws and regulations by management or management may exhibit an inability to oversee the preparation of adequate financial statements, which may raise doubt about management's competence. Accordingly, it may not be appropriate to communicate such deficiencies directly to management.

**.A23** Section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, establishes requirements and provides guidance on the reporting of identified or suspected noncompliance with laws and regulations, including when those charged with governance are themselves involved in such noncompliance.<sup>6</sup> Section 240, *Consideration of Fraud in a Financial Statement Audit*, establishes requirements and provides guidance regarding communication to those charged with governance when the auditor has identified fraud or suspected fraud involving management.<sup>7</sup>

***Communication of Other Deficiencies in Internal Control to Management*** (Ref: par. .12b)

**.A24** During the audit, the auditor may identify other deficiencies in internal control that are not significant deficiencies or material weaknesses but that may be of sufficient importance to merit management's attention. The determination regarding which other deficiencies in internal control merit management's attention is a matter of the auditor's professional judgment in the circumstances, taking into account the likelihood and potential magnitude of misstatements that may arise in the financial statements as a result of those deficiencies.

**.A25** The communication of other deficiencies in internal control that merit management's attention need not be in writing. When the auditor has discussed the facts and circumstances of the auditor's findings with management, the auditor may consider an oral communication of the other deficiencies to have been made to management at the time of these discussions. Accordingly, a formal communication need not be made subsequently.

<sup>6</sup> Paragraphs .21–.27 of section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*. [Footnote renumbered by the issuance of SAS No. 125, December 2011.]

<sup>7</sup> Paragraph .40 of section 240, *Consideration of Fraud in a Financial Statement Audit*. [Footnote renumbered by the issuance of SAS No. 125, December 2011.]

**.A26** If the auditor has communicated deficiencies in internal control, other than significant deficiencies or material weaknesses, to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor need not repeat the communication in the current period. The auditor also is not required to repeat information about such deficiencies if the information has been previously communicated to management by other parties, such as the internal audit function or regulators. However, the auditor may consider it appropriate to recommunicate these other deficiencies if there has been a change of management or if new information has come to the auditor's attention that alters the prior understanding of the auditor and management regarding the deficiencies. Nevertheless, the failure of management to remedy other deficiencies in internal control that were previously communicated may become a significant deficiency requiring communication with those charged with governance. Whether this is the case depends on the auditor's professional judgment in the circumstances. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

**.A27** In some circumstances, those charged with governance may wish to be made aware of the details of other deficiencies in internal control that the auditor has communicated to management or be briefly informed of the nature of the other deficiencies. Alternatively, the auditor may inform those charged with governance when a communication of other deficiencies has been made to management. In either case, the auditor may communicate orally or in writing to those charged with governance, as appropriate.

***Considerations Specific to Governmental Entities (Ref: par. .11–.12)***

**.A28** Auditors performing audits of governmental entities may have additional responsibilities to communicate deficiencies in internal control that the auditor identified during the audit, in a different format, at a level of detail or to parties not envisioned in this section. For example, significant deficiencies and material weaknesses may have to be communicated to a governmental authority, and such communications may be required to be made publicly available. Law or regulation also may require auditors to report deficiencies in internal control, irrespective of their severity. Further, law or regulation may require auditors to report on broader internal control-related matters (for example, controls related to compliance with law, regulation, or provisions of contracts or grant agreements).<sup>8</sup>

***Content of Written Communication of Significant Deficiencies and Material Weaknesses in Internal Control (Ref: par. .14–.16)***

**.A29** In explaining the potential effects of the significant deficiencies and material weaknesses, the auditor need not quantify those effects. The potential effects may be described in terms of the control objectives and types of errors the control was designed to prevent, or detect and correct, or in terms of the risk(s) of misstatement that the control was designed to address. The potential effects may be evident from the description of the significant deficiencies or material weaknesses.

**.A30** The significant deficiencies or material weaknesses may be grouped together for reporting purposes when it is appropriate to do so. The auditor also may include in the written communication suggestions for remedial action

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<sup>8</sup> See section 935, *Compliance Audits*. [Footnote renumbered by the issuance of SAS No. 125, December 2011.]



on the deficiencies, management's actual or proposed responses, and a statement about whether the auditor has undertaken any steps to verify whether management's responses have been implemented (see paragraph .A33).

**.A31** The auditor may consider it appropriate to include the following information as additional context for the communication:

- The general inherent limitations of internal control, including the possibility of management override of controls
- The specific nature and extent of the auditor's consideration of internal control during the audit

***Restriction on Use (Ref: par. .14d)***

**.A32** In certain cases not involving *Government Auditing Standards*, law or regulation may require the auditor or management to furnish a copy of the auditor's written communication on significant deficiencies and material weaknesses to governmental authorities. When this is the case, the auditor's written communication may identify such governmental authorities in the paragraph containing the alert that restricts the use of the auditor's written communication. Section 905 does not permit the auditor to add parties, other than those identified in paragraph .07b of that section.<sup>9</sup> [As amended, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125.]

***Management's Written Response***

**.A33** Management may wish to or may be required by a regulator to prepare a written response to the auditor's communication regarding significant deficiencies or material weaknesses identified during the audit. Such management communications may include a description of corrective actions taken by the entity, the entity's plans to implement new controls, or a statement indicating that management believes the cost of correcting a significant deficiency or material weakness would exceed the benefits to be derived from doing so. If such a written response is included in a document containing the auditor's written communication to management and those charged with governance concerning identified significant deficiencies or material weaknesses, the auditor may add a paragraph to the written communication disclaiming an opinion on such information. The following is an example of such a paragraph:

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

***No Material Weakness Communications (Ref: par. .15–.16)***

**.A34** Management or those charged with governance may request a written communication indicating that no material weaknesses were identified during the audit. A written communication indicating that no material weaknesses were identified during the audit does not provide any assurance about the effectiveness of an entity's internal control over financial reporting. However, an auditor is not precluded from issuing such a communication, provided that the communication includes the matters required by paragraph .15. However, a

<sup>9</sup> Paragraph .08 of section 905. [Footnote added, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125.]

written communication indicating that no significant deficiencies were identified during the audit is precluded by paragraph .16 because such a communication has the potential to be misunderstood or misused.

**.A35** Exhibit B, "Illustrative No Material Weakness Communication," includes an illustrative communication indicating that no material weaknesses were identified during the audit.

*Considerations Specific to Governmental Entities*

**.A36** A written communication indicating that no material weaknesses were identified during the audit may be required to be furnished to governmental authorities. As described in paragraph .A32, the auditor's written communication may identify the governmental authority as a specified party in the restricted use paragraph. The auditor is not permitted to add other parties as specified parties.

.A37

## Appendix—Examples of Circumstances That May Be Deficiencies, Significant Deficiencies, or Material Weaknesses

Paragraph .A11 identifies indicators of material weaknesses in internal control. The following are examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses.

### Deficiencies in the Design of Controls

The following are examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses related to the design of controls:

- Inadequate design of controls over the preparation of the financial statements being audited.
- Inadequate design of controls over a significant account or process.
- Inadequate documentation of the components of internal control.
- Insufficient control consciousness within the organization (for example, the tone at the top and the control environment).
- Evidence of ineffective aspects of the control environment, such as indications that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance.
- Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
- Evidence of an ineffective response to identified significant risks (for example, absence of controls over such a risk).
- Absent or inadequate segregation of duties within a significant account or process.
- Absent or inadequate controls over the safeguarding of assets (this applies to controls that the auditor determines would be necessary for effective internal control over financial reporting).
- Inadequate design of IT general and application controls that prevents the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
- Employees or management who lack the qualifications and training to fulfill their assigned functions. For example, in an entity that prepares financial statements in accordance with generally accepted accounting principles (GAAP), the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP in recording the entity's financial transactions or preparing its financial statements.
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity's internal control over time.

- Absence of an internal process to report deficiencies in internal control to management on a timely basis.
- Absence of a risk assessment process within the entity when such a process would ordinarily be expected to have been established.

### Failures in the Operation of Controls

The following are examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses related to the operation of controls:

- Failure in the operation of effectively designed controls over a significant account or process (for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process).
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy (for example, the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements).
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. This circumstance may need careful consideration before it is evaluated as a significant deficiency or material weakness. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs timely periodic physical inventory counts (detective control) with regard to its financial reporting. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely. Therefore, given that the definitions of *material weakness* and *significant deficiency* relate to the likelihood of misstatement of the financial statements, the failure of a preventive control, such as inventory tags, will not result in a significant deficiency or material weakness if the detective control (physical inventory counts) prevents a misstatement of the financial statements. Material weaknesses relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent, or detect and correct, a material misstatement of the financial statements.
- Failure to perform reconciliations of significant accounts. For example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.
- Undue bias or lack of objectivity by those responsible for accounting decisions (for example, consistent understatement of expenses or overstatement of allowances at the direction of management).
- Misrepresentation by entity personnel to the auditor (an indicator of fraud).
- Management override of controls.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.
- An observed deviation rate that exceeds the number of deviations expected by the auditor in a test of the operating effectiveness of

a control. For example, if the auditor designs a test in which he or she selects a sample and expects no deviations, the finding of one deviation is a nonnegligible deviation rate because based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.

.A38

## Exhibit A—Illustrative Auditor's Written Communication

The following is an illustrative auditor's written communication encompassing the requirements in paragraph .14.

To Management and *[identify the body or individuals charged with governance, such as the entity's Board of Directors]* of ABC Company

In planning and performing our audit of the financial statements of ABC Company (the "Company") as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be *[material weaknesses or material weaknesses or significant deficiencies]* and therefore, *[material weaknesses or material weaknesses or significant deficiencies]* may exist that were not identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be *[material weaknesses or significant deficiencies or material weaknesses and significant deficiencies]*.

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

*[Describe the material weaknesses that were identified and an explanation of their potential effects.]*

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

*[Describe the significant deficiencies that were identified and an explanation of their potential effects.]*

*[If the auditor is communicating significant deficiencies and did not identify any material weaknesses, the auditor may state that none of the identified significant deficiencies are considered to be material weaknesses.]*

This communication is intended solely for the information and use of management, *[identify the body or individuals charged with governance]*, others within the organization, and *[identify any governmental authorities to which*

*the auditor is required to report*] and is not intended to be, and should not be, used by anyone other than these specified parties.<sup>1</sup>

[Auditor's signature]

[Auditor's city and state]

[Date]

[As amended, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125.]

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<sup>1</sup> When the engagement is also performed in accordance with *Government Auditing Standards*, the alert required by paragraph .14d may read as follows: "The purpose of this communication is solely to describe the scope of our testing of internal control over financial reporting and the results of that testing. This communication is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Company's internal control over financial reporting. Accordingly, this communication is not suitable for any other purpose." The AICPA Audit Guide *Government Auditing Standards and Circular A-133 Audits* provides additional interpretative guidance, including illustrative reports. [Footnote added, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125.]

.A39

## Exhibit B—Illustrative No Material Weakness Communication

The following is an illustrative auditor's written communication indicating that no material weaknesses were identified during the audit of a not-for-profit organization.

To Management and *[identify the body or individuals charged with governance, such as the entity's Board of Directors]* of NPO Organization

In planning and performing our audit of the financial statements of NPO Organization (the "Organization") as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered the Organization's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Organization's internal control. Accordingly, we do not express an opinion on the effectiveness of the Organization's internal control.

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

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

*[If one or more significant deficiencies have been identified, the auditor may add the following: Our audit was also not designed to identify deficiencies in internal control that might be significant deficiencies. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We communicated the significant deficiencies identified during our audit in a separate communication dated [date].]*

This communication is intended solely for the information and use of management, *[identify the body or individuals charged with governance]*, others within the organization, and *[identify any governmental authorities to which the auditor is required to report]* and is not intended to be, and should not be, used by anyone other than these specified parties.<sup>1</sup>

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<sup>1</sup> When the engagement is also performed in accordance with *Government Auditing Standards*, the alert required by paragraph .14d may read as follows: "The purpose of this communication is solely to describe the scope of our testing of internal control over financial reporting and the results of that testing. This communication is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Company's internal control over financial reporting. Accordingly, this communication is not suitable for any other purpose." The AICPA Audit Guide *Government Auditing Standards and Circular A-133 Audits* provides additional interpretative guidance, including illustrative reports. [Footnote added, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125.]



*[Auditor's signature]*

*[Auditor's city and state]*

*[Date]*

[As amended, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125.]

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## AU-C Section 610

### *Using the Work of Internal Auditors*

Source: SAS No. 128.

Effective for audits of financial statements for periods ending on or after December 15, 2014.

#### Introduction

##### Scope of This Section

**.01** This section addresses the external auditor's responsibilities if using the work of internal auditors. Using the work of internal auditors includes (a) using the work of the internal audit function in obtaining audit evidence and (b) using internal auditors to provide direct assistance under the direction, supervision, and review of the external auditor.

**.02** This section does not apply if the entity does not have an internal audit function. (Ref: par. .A1–.A2)

**.03** If the entity has an internal audit function, the requirements in this section relating to using the work of the internal audit function in obtaining audit evidence do not apply if

- a. the responsibilities and activities of the function are not relevant to the audit, or
- b. based on the external auditor's preliminary understanding of the function obtained as a result of procedures performed under section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, the external auditor does not expect to use the work of the function in obtaining audit evidence.

Nothing in this section requires the external auditor to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor; it remains the external auditor's decision to establish the overall audit strategy.

**.04** Furthermore, the requirements in this section relating to using internal auditors to provide direct assistance do not apply if the external auditor does not plan to use internal auditors to provide direct assistance.

##### Relationship Between Section 315 and This Section

**.05** Many entities establish internal audit functions as part of their internal control and governance structures. The objectives and scope of an internal audit function, the nature of its responsibilities, and its organizational status, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and those charged with governance. section 315 addresses how the knowledge and experience of the internal audit function can inform the external auditor's

understanding of the entity and its environment and identification and assessment of risks of material misstatement. section 315<sup>1</sup> also explains how effective communication between the internal and external auditors creates an environment in which the external auditor can be informed by the internal auditor of significant matters that may affect the external auditor's work.

**.06** The external auditor may be able to use the work of the internal audit function in obtaining audit evidence in a constructive and complementary manner depending on

- the level of competency of the internal audit function,
- whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, and
- whether the function applies a systematic and disciplined approach, including quality control.

This section addresses the external auditor's responsibilities when, based on the external auditor's understanding of the internal audit function obtained as a result of procedures performed under section 315, the external auditor expects to use the work of the internal audit function in obtaining audit evidence (see paragraphs .13–.24 of this section). Such use of that work modifies the nature or timing, or reduces the extent, of audit procedures to be performed directly by the external auditor.

**.07** This section also addresses the external auditor's responsibilities if the external auditor is considering using internal auditors to provide direct assistance under the direction, supervision, and review of the external auditor (see paragraphs .25–.32).

**.08** There may be individuals in an entity that perform procedures similar to those performed by an internal audit function. However, unless performed by an objective and competent function that applies a systematic and disciplined approach, including quality control, such procedures would be considered control activities, and obtaining evidence regarding the effectiveness of such controls would be part of the external auditor's responses to assessed risks in accordance with section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

## The External Auditor's Responsibility for the Audit

**.09** The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function in obtaining audit evidence or use of internal auditors to provide direct assistance on the engagement. Although the function may perform audit procedures similar to those performed by the external auditor, neither the internal audit function nor the internal auditors are independent of the entity as is required of the external auditor in an audit of financial statements in accordance with section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.<sup>2</sup> This section, therefore, defines the

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<sup>1</sup> Paragraph .A120 of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

<sup>2</sup> Paragraph .15 of section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.

conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function or internal auditors providing direct assistance is adequate for the purposes of the audit. The requirements are designed to provide a framework for the external auditor's judgments regarding the use of the work of internal auditors to prevent over or undue use of such work.

## Effective Date

.10 This section is effective for audits of financial statements for periods ending on or after December 15, 2014.

## Objectives

.11 The objectives of the external auditor, when the entity has an internal audit function and the external auditor expects to use the work of internal auditors to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor, are as follows:

- a. To determine whether to use the work of the internal audit function in obtaining audit evidence or to use internal auditors to provide direct assistance, and if so, in which areas and to what extent
- b. If using the work of the internal audit function in obtaining audit evidence, to determine whether that work is adequate for purposes of the audit
- c. If using internal auditors to provide direct assistance, to appropriately direct, supervise, and review their work

## Definitions

.12 For purposes of generally accepted auditing standards, the following terms have the meaning attributed as follows:

**Direct assistance.** The use of internal auditors to perform audit procedures under the direction, supervision, and review of the external auditor.

**Internal audit function.** A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management, and internal control processes. (Ref: par. .A1–.A4)

## Requirements

### Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used in Obtaining Audit Evidence

#### *Evaluating the Internal Audit Function*

.13 The external auditor should determine whether the work of the internal audit function can be used in obtaining audit evidence by evaluating

- a. the extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; (Ref: par. .A5–.A11)
- b. the level of competence of the internal audit function; and (Ref: par. .A5–.A9)
- c. the application by the internal audit function of a systematic and disciplined approach, including quality control. (Ref: par. .A12–.A14)

**.14** The external auditor should not use the work of the internal audit function in obtaining audit evidence if the external auditor determines that

- a. the function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
- b. the function lacks sufficient competence; or
- c. the function does not apply a systematic and disciplined approach, including quality control. (Ref: par. .A15–.A17)

***Determining the Nature and Extent of Work of the Internal Audit Function That Can Be Used in Obtaining Audit Evidence***

**.15** As a basis for determining the areas and the extent to which the work of the internal audit function can be used, the external auditor should consider the nature, timing, and extent of the work that has been performed, or is planned to be performed, by the internal audit function and its relevance to the external auditor's overall audit strategy and audit plan. (Ref: par. .A18–.A23)

**.16** The external auditor should make all significant judgments in the audit engagement, including when using the work of the internal audit function in obtaining audit evidence. (Ref: par. .A18)

**.17** To prevent undue use of the internal audit function in obtaining audit evidence, the external auditor should plan to use less of the work of the function and perform more of the work directly: (Ref: par. .A19–.A24)

- a. The more judgment is involved in
  - i. planning and performing relevant audit procedures or
  - ii. evaluating the audit evidence obtained (Ref: par. .A24)
- b. the higher the assessed risk of material misstatement at the assertion level, with special consideration given to significant risks; (Ref: par. .A25–.A27)
- c. the less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and
- d. the lower the level of competence of the internal audit function.

**.18** The external auditor should also evaluate whether, in aggregate, using the work of the internal audit function in obtaining audit evidence to the extent planned, together with any planned use of internal auditors to provide direct assistance, would result in the external auditor still being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed. (Ref: par. .A18–.A27 and .A44)

***Communicating With Those Charged With Governance***

**.19** In communicating an overview of the planned scope and timing of the audit to those charged with governance in accordance with section 260,

*The Auditor's Communication With Those Charged With Governance*,<sup>3</sup> the external auditor should communicate how the external auditor has planned to use the work of the internal audit function in obtaining audit evidence. (Ref: par. .A28)

### **Using the Work of the Internal Audit Function in Obtaining Audit Evidence**

**.20** If the external auditor plans to use the work of the internal audit function in obtaining audit evidence, the external auditor should discuss the planned use of the work with the function as a basis for coordinating their respective activities. (Ref: par. .A29–.A32)

**.21** The external auditor should read the reports of the internal audit function, which relate to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures the internal audit function performed and the related findings.

**.22** The external auditor should perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit, including evaluating whether

- a. the work of the function was properly planned, performed, supervised, reviewed, and documented;
- b. sufficient appropriate evidence was obtained to enable the function to draw reasonable conclusions; and
- c. conclusions reached are appropriate in the circumstances, and the reports prepared by the function are consistent with the results of the work performed. (Ref: par. .A33–.A36)

**.23** The nature and extent of the external auditor's audit procedures should be responsive to the external auditor's evaluation of

- a. the amount of judgment involved in
  - i. planning and performing relevant audit procedures and
  - ii. evaluating the audit evidence obtained;
- b. the assessed risk of material misstatement;
- c. the extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; and
- d. the level of competence of the function. (Ref: par. .A33–.A35) (see paragraphs .16–.17)

The external auditor should also reperform some of the body of work of the internal audit function that the external auditor intends to use in obtaining audit evidence. (Ref: par. .A36)

**.24** Before the conclusion of the audit, the external auditor should evaluate whether the external auditor's conclusions regarding the internal audit function in paragraph .13 and the determination of the nature and extent of use of the work of the function for purposes of the audit in paragraphs .16–.18 remain appropriate.

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<sup>3</sup> Paragraph .11 of section 260, *The Auditor's Communication With Those Charged With Governance*.

## **Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance**

### ***Determining Whether Internal Auditors Can Be Used to Provide Direct Assistance for Purposes of the Audit***

**.25** If the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor should evaluate the existence and significance of threats to the objectivity of the internal auditors who will be providing direct assistance, as well as any safeguards applied to reduce or eliminate the threats, and the level of competence of the internal auditors who will be providing such assistance. (Ref: par. .A37–.A41)

**.26** The external auditor should not use an internal auditor to provide direct assistance if

- a. the internal auditor lacks the necessary objectivity to perform the proposed work, or
- b. the internal auditor lacks the necessary competence to perform the proposed work. (Ref: par. .A37–.A41)

### ***Determining the Nature and Extent of Work That Can Be Assigned to Internal Auditors Providing Direct Assistance***

**.27** In determining the nature and extent of work that may be assigned to internal auditors providing direct assistance and the nature, timing, and extent of direction, supervision, and review that is appropriate in the circumstances, the external auditor should consider

- a. the external auditor's evaluation of the existence and significance of threats to the internal auditors' objectivity, the effectiveness of the safeguards applied to reduce or eliminate the threats, and the level of competence of the internal auditors who will be providing such assistance;
- b. the assessed risk of material misstatement; and
- c. the amount of judgment involved in
  - i. planning and performing relevant audit procedures and
  - ii. evaluating the audit evidence obtained. (Ref: par. .A42–.A43)

### ***Communicating With Those Charged With Governance***

**.28** In communicating an overview of the planned scope and timing of the audit with those charged with governance in accordance with section 260,<sup>4</sup> the external auditor should communicate how the external auditor plans to use internal auditors to provide direct assistance.

### ***Using Internal Auditors to Provide Direct Assistance***

**.29** The external auditor should evaluate whether, in aggregate, using internal auditors to provide direct assistance to the extent planned, together with any planned use of the work of the internal audit function in obtaining audit evidence, would result in the external auditor still being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed. (Ref: par. .A44)

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<sup>4</sup> See footnote 3.

**.30** Prior to using internal auditors to provide direct assistance, the external auditor should obtain written acknowledgment from management or those charged with governance, as appropriate, that internal auditors providing direct assistance to the external auditor will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor. (Ref: par. .A45)

**.31** The external auditor should direct, supervise, and review the work performed by internal auditors on the engagement in accordance with section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*. In so doing

- a. the nature, timing, and extent of direction, supervision, and review should be responsive to the outcome of the evaluation of the factors in paragraph .27 of this section;
- b. the external auditor should instruct the internal auditors to bring accounting and auditing issues identified during the audit to the attention of the external auditor; and
- c. the review procedures should include the external auditor testing some of the work performed by the internal auditors. (Ref: par. .A46–.A47)

**.32** When directing, supervising, and reviewing the work performed by internal auditors, the external auditor should remain alert for indications that the external auditor's evaluations in paragraphs .25 and .29 are no longer appropriate.

## Documentation

**.33** If the external auditor uses the work of the internal audit function in obtaining audit evidence, the external auditor should include the following in the audit documentation:<sup>5</sup>

- a. The results of the evaluation of
  - i. the function's organizational status and relevant policies and procedures to adequately support the objectivity of the internal auditors;
  - ii. the level of competence of the function; and
  - iii. the application by the function of a systematic and disciplined approach, including quality control
- b. The nature and extent of the work used (including the period covered by, and the results of, such work) and the basis for that decision
- c. The audit procedures performed by the external auditor to evaluate the adequacy of the work used, including the procedures performed by the external auditor to reperform some of the body of work of the internal audit function in obtaining audit evidence

**.34** If the external auditor uses internal auditors to provide direct assistance on the audit, the external auditor should include the following in the audit documentation:

- a. The evaluation of the existence and significance of threats to the objectivity of the internal auditors, as well as any safeguards applied to reduce or eliminate the threats, and the level of competence of the internal auditors used to provide direct assistance

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<sup>5</sup> Paragraphs .08–.12 and .A8 of section 230, *Audit Documentation*.



- b. The basis for the decision regarding the nature and extent of the work performed by the internal auditors
- c. The nature and extent of the external auditor's review of the internal auditors' work (including the testing, by the external auditor, of some of the work performed by the internal auditors) in accordance with section 230, *Audit Documentation*
- d. The working papers prepared by the internal auditors who provided direct assistance on the audit engagement

**.35** If the external auditor uses either the work of the internal audit function in obtaining audit evidence or internal auditors to provide direct assistance, or both, the external auditor should include in the audit documentation the external auditor's evaluation of (see paragraphs .18 and .29) whether, either individually or in aggregate as applicable, using the work of the internal audit function in obtaining audit evidence and use of internal auditors to provide direct assistance resulted in the external auditor still being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

## Application and Other Explanatory Material

### Definition of *Internal Audit Function* (Ref: par. .02 and .12)

**.A1** The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management, and internal control processes, such as the following:

#### *Activities Relating to Governance Process*

- The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization, and effectiveness of communication among those charged with governance, external and internal auditors, and management.

#### *Activities Relating to Risk Management Process*

- The internal audit function may assist the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process).
- The internal audit function may perform procedures to assist the entity in the detection of fraud.

#### *Activities Relating to Internal Control Process*

- *Evaluation of internal control.* The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation, and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation, and operating effectiveness of internal control, including those controls that are relevant to the audit.

- *Examination of financial and operating information.* The internal audit function may be assigned to review the means used to identify, recognize, measure, classify, and report financial and operating information and to make specific inquiry into individual items, including detailed testing of transactions, balances, and procedures.
- *Review of operating activities.* The internal audit function may be assigned to review the economy, efficiency, and effectiveness of operating activities, including nonfinancial activities of an entity.
- *Review of compliance with laws and regulations.* The internal audit function may be assigned to review compliance with laws, regulations, and other external requirements and with management policies and directives and other internal requirements.

Not all the activities discussed in this paragraph need to be present for an internal audit function to be used in the audit of the financial statements. The external auditor may be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor in obtaining audit evidence if the nature of the internal audit function's responsibilities and assurance activities is related to the entity's financial reporting, as further discussed in section 315.<sup>6</sup>

**.A2** Activities similar to those performed by an internal audit function may be conducted by functions with other titles within an entity. Some or all of the activities of an internal audit function may also be outsourced to a third-party service provider. Neither the title of the function nor whether it is performed by the entity or a third-party service provider are sole determinants of whether the external auditor can use the work of internal auditors. Rather, it is the nature of the activities, the extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors, competence of the internal auditors, and systematic and disciplined approach of the function that are relevant. References in this section to the work of the internal audit function include relevant activities of other functions or third-party providers that have these characteristics.

**.A3** However, those in the entity with operational and managerial duties and responsibilities outside of the internal audit function would ordinarily face threats to their objectivity that would preclude them from being treated as part of an internal audit function for the purpose of this section, although they may perform control activities that can be tested in accordance with section 330.<sup>7</sup> For this reason, monitoring controls performed by an owner-manager would not be considered equivalent to an internal audit function.

**.A4** Although the objectives of an entity's internal audit function and the external auditor differ, the function may perform audit procedures similar to those performed by the external auditor in an audit of financial statements. If so, the external auditor may make use of the function for purposes of the audit in one or both of the following ways:

- To obtain information that is relevant to the external auditor's assessments of the risks of material misstatement due to error or fraud. In this regard, section 315<sup>8</sup> requires the external auditor

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<sup>6</sup> Paragraph .A117 of section 315.

<sup>7</sup> Paragraph .10 of section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

<sup>8</sup> Paragraphs .06a and .24 of section 315.

to obtain an understanding of the nature of the internal audit function's responsibilities, its status within the organization, and the activities performed, or to be performed, and make inquiries of appropriate individuals within the internal audit function (if the entity has such a function).

- The external auditor, after appropriate evaluation, may decide to use work that has been performed by the internal audit function that is relevant to the period being audited to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor (that is, the external auditor can use the work of the internal audit function in partial substitution for audit evidence to be obtained directly by the external auditor) (see paragraphs .13–.24 of this section).

In addition, the external auditor may use internal auditors to perform audit procedures under the direction, supervision, and review of the external auditor (referred to as *direct assistance* in this section) (see paragraphs .25–.32 of this section).

## Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used in Obtaining Audit Evidence

### *Evaluating the Internal Audit Function*

*Objectivity and Competence (Ref. par. .13a–b)*

**.A5** The external auditor exercises professional judgment in determining whether the work of the internal audit function can be used in obtaining audit evidence and the nature and extent to which the work of the internal audit function can be used in the circumstances.

**.A6** The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors and the level of competence of the function are particularly important in determining whether to use the work of the internal audit function in obtaining audit evidence and, if so, the nature and extent of the use of the work of the function that is appropriate in the circumstances.

**.A7** *Objectivity* refers to the ability to perform tasks without allowing bias, conflict of interest, or undue influence of others to override professional judgments. Factors that may affect the external auditor's evaluation of objectivity include the following:

- Whether the organizational status of the internal audit function, including the function's authority and accountability, supports the ability of the function to be free from bias, conflict of interest, or undue influence of others to override professional judgments (for example, whether the internal audit function reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance)
- Whether the internal audit function is free of any conflicting responsibilities (for example, having managerial or operational duties or responsibilities that are outside of the internal audit function)

- Whether those charged with governance oversee employment decisions related to the internal audit function (for example, determining the appropriate remuneration policy)
- Whether any constraints or restrictions placed on the internal audit function by management or those charged with governance exist (for example, in communicating the internal audit function's findings to the external auditor)
- Whether the internal auditors are members of relevant professional bodies and their memberships obligate their compliance with relevant professional standards relating to objectivity or whether their internal policies achieve the same objectives

**.A8** *Competence* of the internal audit function refers to the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable assigned tasks to be performed diligently and with the appropriate level of quality. Factors that may affect the external auditor's determination about competence include the following:

- Whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations.
- Whether established policies for hiring, training, and assigning internal auditors to internal audit engagements exist.
- Whether the internal auditors have adequate technical training and proficiency in auditing. Relevant criteria that may be considered by the external auditor in making the assessment may include, for example, the internal auditors' possession of a relevant professional designation and experience.
- Whether the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework and whether the internal audit function possesses the necessary skills (for example, industry-specific knowledge) to perform work related to the entity's financial statements.
- Whether the internal auditors are members of relevant professional bodies or have certifications that oblige them to comply with the relevant professional standards, including continuing professional education requirements.

**.A9** Objectivity and competence may be viewed as a continuum. The more the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the higher the level of competence of the function, the more likely the external auditor may make use of the work of the function in obtaining audit evidence and make use of it in more areas. However, an organizational status and relevant policies and procedures that provide strong support for the objectivity of the internal auditors cannot compensate for the lack of sufficient competence of the internal audit function. Equally, a high level of competence of the internal audit function cannot compensate for an organizational status and policies and procedures that do not adequately support the objectivity of the internal auditors. Additionally, neither a high level of competence nor strong support for the objectivity of the internal auditors compensate for the lack of a systematic and disciplined approach.

*Considerations Specific to Governmental Entities (Ref: par. .13a)*

**.A10** *Generally Accepted Government Auditing Standards* (GAGAS), established by the U.S. Government Accountability Office, addresses the evaluation of the internal audit function in a government environment, including consideration of whether the internal audit function

- reports to senior management, such as a city manager or finance director,
- reports to the governing body,
- is elected, and, thus, is accountable to the citizens, or
- reports to an audit committee, which may comprise the governing body or a subcommittee thereof, members of senior management, appointed citizens, or any combination thereof.

**.A11** The GAGAS conceptual framework approach provides auditors a practicable approach to address threats to independence and can be applied to varying circumstances that could potentially create threats to independence. The GAGAS conceptual framework may be useful in evaluating the objectivity of the internal audit function of a governmental entity.

*Application of a Systematic and Disciplined Approach, Including Quality Control (Ref: par. .13c)*

**.A12** The application of a systematic and disciplined approach to planning, performing, supervising, reviewing, and documenting its activities distinguishes the activities of the internal audit function from other monitoring control activities that may be performed within the entity.

**.A13** Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following:

- The existence, adequacy, and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation, and reporting, the nature and extent of which is commensurate with the nature and size of the internal audit function relative to the complexity of the entity.
- Whether the internal audit function has appropriate quality control policies and procedures (for example, those relating to leadership, human resources, and engagement performance) or quality control requirements in standards set by relevant professional bodies for internal auditors. Such bodies may also establish other appropriate requirements, such as conducting periodic external quality assessments.

**.A14** The external auditor's determination of whether the internal audit function applies a systematic and disciplined approach is intended to address the risk that the external auditor inappropriately uses internal audit-like work performed in an informal, unstructured, or ad hoc manner. However, the level of formality of an acceptable approach may vary depending on the nature and size of the internal audit function relative to the complexity of the entity.

*Circumstances in Which Work of the Internal Audit Function Cannot Be Used (Ref: par. .14)*

**.A15** The external auditor's evaluation of whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competence of the internal audit function, and whether it applies a systematic and disciplined

approach may indicate that the risks to the quality of the work of the function are too significant and, therefore, it is not appropriate to use any of the work of the function as audit evidence.

**.A16** Consideration of the factors in paragraphs .A7–.A8 and .A13, individually and in aggregate, is important because an individual factor is often not sufficient to conclude that the work of the internal audit function cannot be used for purposes of the audit. For example, the internal audit function's organizational status is particularly important in evaluating threats to the objectivity of the internal auditors. If the internal audit function reports to management other than in an administrative capacity, this may impair the function's objectivity absent safeguards applied to reduce or eliminate the threat (for example, having direct access and performance accountability to those charged with governance).

**.A17** In addition, when the external auditor accepts an engagement to provide internal audit services to an audit client, and the results of those services will be used in conducting the audit, a self-review threat is created in regards to the external auditor's independence. This is because of the possibility that the engagement team will use the results of the internal audit service without properly evaluating those results or without exercising the same level of professional skepticism as would be exercised when the internal audit work is performed by individuals who are not members of the firm.

#### ***Determining the Nature and Extent of Work of the Internal Audit Function That Can Be Used in Obtaining Audit Evidence***

*Factors Affecting the Determination of the Nature and Extent of the Work of the Internal Audit Function That Can Be Used (Ref: par. .15–.18)*

**.A18** Because the external auditor has sole responsibility for the audit opinion expressed, the external auditor is required to make the significant judgments in the audit engagement in accordance with paragraph .16. Significant judgments include, but are not limited to, the following:

- Assessing the risks of material misstatement
- Evaluating the sufficiency of tests performed
- Evaluating the appropriateness of management's use of the going concern assumption and whether substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time
- Evaluating significant accounting estimates
- Evaluating the adequacy of disclosures in the financial statements and other matters affecting the external auditor's report

**.A19** Once the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, a first consideration is whether the planned nature and scope of the work of the internal audit function that has been performed, or is planned to be performed, is relevant to the overall audit strategy and audit plan that the external auditor has established in accordance with section 300, *Planning an Audit*.

**.A20** In accordance with section 330, the external auditor is required to design and perform further audit procedures whose nature, timing, and extent are based on, and responsive to, the assessed risks of material misstatement at the relevant assertion level.<sup>9</sup> Further audit procedures comprise tests of controls

<sup>9</sup> Paragraph .06 of section 330.

and substantive procedures. Procedures planned or performed by the internal audit function may be the same as, or be similar to, the further audit procedures that the external auditor would design and perform. Accordingly, subject to the requirements of this section, the external auditor may determine that it is appropriate to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of further audit procedures to be performed directly by the external auditor. The internal audit function may have performed, or may be planning to perform

- tests of relevant controls upon which the external auditor intends to rely in determining the nature, timing, and extent of substantive procedures. For example, the work of the internal audit function may include tests of relevant controls that address the risks of material misstatement related to the completeness of accounts payable. The results of the internal audit function's tests may provide evidence about the effectiveness of controls and, accordingly, the external auditor may be able to use such tests of controls performed by the internal audit function to modify the nature or timing, or reduce the extent of, testing of controls the external auditor would otherwise have performed directly.
- substantive procedures. For example, the internal audit function, as part of its work, may confirm certain accounts receivable and observe certain physical inventories. By using such work of the internal audit function in obtaining audit evidence, the external auditor may be able to change the timing of the confirmation procedures, the number of accounts receivable to be confirmed, or the number of locations of physical inventories to be observed.

The internal audit function's plan may also include procedures related to financial information of components of a group. The external auditor may coordinate work with the internal auditors (in accordance with paragraph .20 of this section) and reduce the number of the entity's components at which the external auditor would otherwise need to perform audit procedures in accordance with the requirements of section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.

**.A21** Other examples of work of the internal audit function that can be used in obtaining audit evidence by the external auditor include the following:

- Tracing transactions through the information system relevant to financial reporting
- Testing of compliance with regulatory requirements

**.A22** The external auditor's determination of the planned nature and extent of use of the work of the internal audit function in obtaining audit evidence will be influenced by the external auditor's evaluation of the extent to which the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the level of competence of the internal audit function in paragraph .13. In addition, the amount of judgment needed in planning, performing, and evaluating such work and the assessed risk of material misstatement at the assertion level are inputs to the external auditor's determination. Further, as described in paragraph .14, circumstances exist in which the external auditor cannot use the work of the internal audit function in obtaining audit evidence for purpose of the audit.

**.A23** When evaluating whether, in aggregate, using the work of the internal audit function to the extent planned, together with any use of internal auditors to provide direct assistance, would result in the external auditor still being sufficiently involved in the audit, the external auditor may consider the external auditor's responsibility to address all relevant requirements of this section, as well as the other standards (for example, in accordance with paragraph .16, the external auditor is required to make all significant judgments). It is not anticipated that the external auditor's evaluation of using work of the internal audit function would be based on a quantitative analysis (for example, percentage of hours spent by internal audit personnel in respect of the work being used by the external auditor relative to total engagement hours).

*Judgments in Planning and Performing Audit Procedures and Evaluating Results (Ref: par. .17a)*

**.A24** As the degree of judgment involved in planning and performing the audit procedures or evaluating the audit evidence increases, the need for the external auditor to perform more procedures directly in accordance with paragraph .17 increases.

*Assessed Risk of Material Misstatement (Ref: par. .17b)*

**.A25** For a particular account balance, class of transaction, or disclosure, the higher an assessed risk of material misstatement at the assertion level, the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In such circumstances, the external auditor will need to perform more procedures directly in accordance with paragraph .17 and, accordingly, make less use of the work of the internal audit function in obtaining sufficient appropriate audit evidence. Furthermore, as explained in section 200,<sup>10</sup> the higher the assessed risks of material misstatement, the more persuasive the audit evidence required by the external auditor will need to be and, therefore, the external auditor will need to perform more of the work directly.

**.A26** As explained in section 315,<sup>11</sup> significant risks require special audit consideration and, therefore, the external auditor's ability to use the work of the internal audit function in relation to significant risks will be restricted to procedures that involve limited judgment. In addition, when the risks of material misstatement is other than low, the use of the work of the internal audit function in obtaining audit evidence alone is unlikely to reduce audit risk to an acceptably low level and eliminate the need for the external auditor to perform some tests directly.

**.A27** Carrying out procedures in accordance with this section may cause the external auditor to reevaluate the assessment of the risks of material misstatement. Consequently, this may affect the external auditor's determination of whether and how to use the work of the internal audit function in obtaining audit evidence.

***Communicating With Those Charged With Governance (Ref: par. .19)***

**.A28** In accordance with section 260,<sup>12</sup> the external auditor is required to communicate an overview of the planned scope and timing of the audit with those charged with governance. The planned use of the work of the internal

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<sup>10</sup> Paragraph .A33 of section 200.

<sup>11</sup> Paragraph .04 of section 315.

<sup>12</sup> Paragraph .11 of section 260.



audit function in obtaining audit evidence is an integral part of the external auditor's overall audit strategy and, therefore, is relevant to those charged with governance for their understanding of the proposed audit approach.

### ***Using the Work of the Internal Audit Function in Obtaining Audit Evidence***

*Discussion and Coordination With the Internal Audit Function in Obtaining Audit Evidence (Ref: par. .20)*

**.A29** In discussing the planned use of the work of the internal audit function in obtaining audit evidence, as a basis for coordinating the respective activities, it may be useful to address the following:

- The timing of such work
- The nature of the work performed
- The extent of audit coverage
- Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances, or disclosures) and performance materiality
- Proposed methods of item selection and sample sizes
- Documentation of the work performed
- Review and reporting procedures

**.A30** Coordination between the external auditor and the internal audit function is effective when, for example

- discussions take place at appropriate intervals throughout the period.
- the external auditor informs the internal audit function of significant matters that may affect the function.
- the external auditor is advised of, and has access to, relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

Although the external auditor is not precluded from using work that the internal audit function has already performed, coordination of activities between the external auditor and internal audit function is likely to be most effective when appropriate interaction occurs before the internal audit function performs the work.

**.A31** Section 200<sup>13</sup> addresses the importance of the external auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.

**.A32** Communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring matters that may affect the work of the external auditor to the external auditor's attention.<sup>14</sup>

<sup>13</sup> Paragraphs .17 and .A22 of section 200.

<sup>14</sup> Paragraph .A120 of section 315.

The external auditor is then able to take such information into account in the external auditor's identification and assessment of risks of material misstatement. In addition, if such information may be indicative of a heightened risk of a material misstatement of the financial statements or may be regarding any actual, suspected, or alleged fraud, the external auditor can take this into account in the external auditor's identification of risk of material misstatement due to fraud in accordance with section 240, *Consideration of Fraud in a Financial Statement Audit*.

*Procedures to Determine the Adequacy of the Work of the Internal Audit Function (Ref: par. .22–.23)*

**.A33** The external auditor's audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use provide a basis for evaluating the overall quality of the function's work and the objectivity with which it has been performed.

**.A34** The procedures the external auditor may perform to evaluate the quality of the work performed and the conclusions reached by the internal audit function, in addition to reperformance in accordance with paragraph .23, include the following:

- Making inquiries of appropriate individuals within the internal audit function
- Observing procedures performed by the internal audit function
- Reviewing the internal audit function's work program and working papers

**.A35** The more judgment involved, the higher the assessed risk of material misstatement, the less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, or the lower the level of competence of the internal audit function, the more audit procedures are needed to be performed by the external auditor on the overall body of work of the internal audit function to support the decision to use the work of the function in obtaining sufficient appropriate audit evidence on which to base the audit opinion.

#### ***Reperformance (Ref: par. .23)***

**.A36** For purposes of this section, *reperformance* involves the external auditor's independent execution of procedures to validate the conclusions reached by the internal audit function. This objective may be accomplished by examining items already examined by the internal audit function or sufficient other similar items not actually examined by the internal audit function. Reperformance provides more persuasive evidence regarding the adequacy of the work of the internal audit function compared to other procedures the external auditor may perform, as described in paragraph .A34. Although it is not necessary for the external auditor to reperform some of the work of the internal audit function in each area that is being used, some reperformance is required on the body of work of the internal audit function as a whole that the external auditor intends to use in accordance with paragraph .23. The external auditor is more likely to focus reperformance in those areas where more judgment was exercised by the internal audit function in planning, performing, and evaluating the results of the audit procedures and in areas of higher risk of material misstatement.

## **Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance**

### ***Determining Whether Internal Auditors Can Be Used to Provide Direct Assistance for Purposes of the Audit (Ref: par. .25–.26)***

**.A37** The external auditor may obtain direct assistance from the internal auditors to carry out audit procedures that otherwise would be performed directly by the external auditors themselves. In such circumstances, the internal auditors are under the direction, supervision, and review of the external auditor.

**.A38** In accordance with paragraph .25, the external auditor evaluates the existence and significance of any threats to the objectivity and level of competence of the internal auditors who will be providing direct assistance on the audit before assigning them to specific tasks. Evaluating the existence and significance of threats to objectivity includes evaluating safeguards applied to reduce or eliminate the threats.

**.A39** As stated in paragraph .A7, *objectivity* refers to the ability to perform the proposed work without allowing bias, conflict of interest, or undue influence of others to override professional judgments. In evaluating the existence and significance of any threats to the objectivity of an individual internal auditor, the external auditor may consider the extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors, including, for example, policies and procedures addressing association with the division or department in the entity to which the work relates. Additionally, other matters may come to the external auditor's attention that may be relevant to the external auditor's evaluation of the objectivity of the internal auditor.

**.A40** In evaluating the level of competence of an internal auditor, many of the factors in paragraph .A8 may also be relevant but in the context of individual internal auditors and the work to which they may be assigned.

**.A41** The external auditor may determine it is necessary to specifically instruct the internal auditors to keep confidential specific matters, as instructed by the external auditor, and to inform the external auditor of any threat to their objectivity. In some situations, the external auditor may determine it to be necessary to request written acknowledgment from the internal auditors of having understood such instruction by the external auditor.

### ***Determining the Nature and Extent of Work That Can Be Assigned to Internal Auditors Providing Direct Assistance (Ref: par. .27)***

**.A42** Paragraphs .A18–.A27 also provide relevant guidance in determining the nature and extent of work that may be assigned to the internal auditors providing direct assistance. As the materiality of the financial statement amounts increases and either the assessed risks of material misstatement or the amount of judgment involved increases, the need for the external auditor to perform procedures directly increases. As these factors decrease, the need for the external auditor to perform procedures directly decreases.

**.A43** In determining the nature of work that may be assigned to internal auditors providing direct assistance, the external auditor is careful to limit such work to those areas that would be appropriate for internal auditors to be assigned. Examples of activities and tasks that would not be appropriate for internal auditors to provide direct assistance include the following:

- Making required inquiries of entity personnel or those charged with governance related to the identification of fraud risks and determining the procedures to respond to such risks<sup>15</sup>
- Determination of unpredictable audit procedures as addressed in section 240

***Using Internal Auditors to Provide Direct Assistance  
(Ref: par. .18 and .29–.31)***

**.A44** If the external auditor plans to use the internal audit function in obtaining audit evidence and also plans to use internal auditors to provide direct assistance, only one evaluation would be necessary to address the requirements of paragraphs .18 and .29.

**.A45** The written acknowledgment required by paragraph .30 may be included within the audit engagement letter (or other suitable form of written agreement of the terms of engagement)<sup>16</sup> or could be included in a separate document prepared by the external auditor and acknowledged in writing by management or those charged with governance, as appropriate.

**.A46** The direction, supervision, and review by the external auditor of the audit procedures performed by the internal auditors need to be sufficient in order for the external auditor to be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions based on that work. Because individuals in the internal audit function are not independent of the entity as is required of the external auditor when expressing an opinion on financial statements, the external auditor's involvement in these circumstances may be of a different nature or more extensive than if members of the engagement team perform the work.

**.A47** The nature, timing, and extent of direction, supervision, and review of the audit procedures performed by the internal auditors is also dependent on the outcome of the external auditor's evaluation of the objectivity and the level of competence of, and the nature and extent of audit procedures to be performed by, the internal auditors. Directing and supervising the internal auditors involves informing them of their responsibilities, the objectives of the procedures they are to perform, and matters that may affect the nature, timing, and extent of audit procedures, such as possible accounting and auditing issues. In reviewing the work performed by the internal auditors, the external auditor's considerations include whether the evidence obtained is sufficient and appropriate in the circumstances, and that it supports the conclusions reached.

<sup>15</sup> Paragraphs .17–.21 of section 240, *Consideration of Fraud in a Financial Statement Audit*.

<sup>16</sup> See paragraph .10 of section 210, *Terms of Engagement*.

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**Exhibit—Comparison of Section 610, *Using the Work of Internal Auditors*, With International Standard on Auditing 610 (Revised 2013), *Using the Work of Internal Auditors***

This analysis was prepared by the Audit and Attest Standards staff to highlight substantive differences between section 610, *Using the Work of Internal Auditors*, and International Standard on Auditing (ISA) 610 (Revised 2013), *Using the Work of Internal Auditors*, and the rationale therefore. This analysis is not authoritative and is prepared for informational purposes only. It has not been acted on or reviewed by the Auditing Standards Board (ASB).

The ASB also made various changes to the language throughout this section in comparison with ISA 610 (Revised 2013). Such changes were made to use terms applicable in the United States and to make section 610 easier to read and apply. The ASB believes that such changes will not create differences between the application of ISA 610 (Revised 2013) and the application of section 610 and, accordingly, these differences are not subsequently discussed.

**Using Internal Auditors to Provide Direct Assistance**

Substantive differences related to the requirements of this section and ISA 610 (Revised 2013) are subsequently described.

***Determining the Nature and Extent of Work That Can Be Assigned to Internal Auditors Providing Direct Assistance***

The ASB did not include paragraph 30 of ISA 610 (Revised 2013) in this section; this paragraph precludes the external auditor's use of internal auditors to provide direct assistance in specified circumstances. The ASB believes that the requirements in paragraphs 30a and 30b were not necessary in the context of audits of nonissuers in the United States. These requirements are partly redundant when compared to the requirement in paragraph .27 of this section regarding the need for the auditor to consider the amount of judgment involved in determining the nature and extent of work to assign to internal auditors and the nature, timing, and extent of the review thereof. Additional application guidance was added to paragraph .A42 of this section to further emphasize that as materiality of the financial statement amounts increases, and either the assessed risks of material misstatement or the amount of judgment involved increases, the need for the external auditor to perform procedures directly increases. The ASB further concluded that the requirements in paragraphs 30c and 30d were not necessary because an appropriate assessment of the objectivity of the internal auditors in accordance with this section would result in a conclusion that it would not be appropriate for internal auditors' work to be used in the situations addressed by those paragraphs.

Paragraph 31 of ISA 610 (Revised 2013) establishes a requirement that, in communicating with those charged with governance, an overview of the planned

scope and timing of the audit in accordance with ISA 260, *Communication with Those Charged with Governance*, the external auditor should communicate the nature and extent of the planned use of internal auditors to provide direct assistance so as to reach a mutual understanding that such use is not excessive in the circumstances of the engagement. The ASB decided to revise paragraph 31 of ISA 610 (Revised 2013) to improve the clarity of the requirement and eliminate the requirement to explicitly obtain a mutual understanding with those charged with governance that the proposed nature and extent of the use of internal auditors to provide direct assistance is not excessive because it was not considered necessary in the context of audits of nonissuers in the United States. Making the communication required by paragraph .28 of this section provides those charged with governance the opportunity to voice any concerns.

*Using Internal Auditors to Provide Direct Assistance*

Paragraph 33b of ISA 610 (Revised 2013) requires that, prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity. Given the established practice and historical experience of using internal auditors to provide direct assistance, the ASB did not believe that it was necessary to include this requirement for the audits of nonissuers in the United States. However, the ASB added application material to indicate that the auditor may determine it necessary to instruct the internal auditors to keep specific matters confidential, and in some situations, may determine it to be necessary to request written acknowledgement from the internal auditors of having understood such instruction (see paragraph .A41).

Paragraph 34a of ISA 610 (Revised 2013) states the following:

The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with ISA 220. In so doing:

- a. The nature, timing and extent of direction, supervision, and review shall recognize that the internal auditors are not independent of the entity and be responsive to the outcome of the evaluation of the factors in paragraph 29 of this ISA.

In paragraph .31a of this section, the ASB decided to delete the phrase *recognize that the internal auditors are not independent of the entity* because the ASB did not believe there was any incremental effect of the phrase on the nature, timing, and extent of the external auditor's required actions. The ASB also believes that the fact that internal auditors are not independent of the entity is already implicit in, and encompassed by, the external auditor's evaluation of the factors in paragraph .27 of this section.

The ASB decided to add paragraph .31b, which represents a requirement to instruct internal auditors to bring accounting and auditing issues to the attention of the external auditors. The ASB believes that it is important to include this requirement, which is included in this section.

Finally, in paragraph .31c, the ASB decided to revise paragraph 34b of ISA 610 (Revised 2013) to express the requirement in terms more commonly understood in the United States and that are more consistent with the terminology in this section.

**AU-C Section 560*****Subsequent Events and Subsequently Discovered Facts***

Source: SAS No. 122.

Effective for audits of financial statements for periods ending on or after December 15, 2012.

**Introduction****Scope of This Section**

.01 This section addresses the auditor's responsibilities relating to subsequent events and subsequently discovered facts in an audit of financial statements. It also addresses a predecessor auditor's responsibilities for subsequent events and subsequently discovered facts when reissuing the auditor's report on previously issued financial statements that are to be presented on a comparative basis with audited financial statements of a subsequent period. (Ref: par. .A1)

**Subsequent Events and Subsequently Discovered Facts**

.02 Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:

- a. Those that provide evidence of conditions that existed at the date of the financial statements
- b. Those that provide evidence of conditions that arose after the date of the financial statements

.03 Section 700, *Forming an Opinion and Reporting on Financial Statements*, explains that the date of the auditor's report informs the user of the auditor's report that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.<sup>1</sup> Accordingly, this section addresses the auditor's responsibilities relating to subsequent events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements. It also addresses the auditor's responsibilities relating to subsequently discovered facts that become known to the auditor after the date of the auditor's report.

**Effective Date**

.04 This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

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<sup>1</sup> Paragraph .A38 of section 700, *Forming an Opinion and Reporting on Financial Statements*.

## Objectives

.05 The objectives of the auditor are to

- a. obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements in accordance with the applicable financial reporting framework and
- b. respond appropriately to facts that become known to the auditor after the date of the auditor's report that, had they been known to the auditor at that date, may have caused the auditor to revise the auditor's report.

.06 The objective of a predecessor auditor who is requested to reissue a previously issued auditor's report on financial statements that are to be presented on a comparative basis with audited financial statements of a subsequent period is to perform specified procedures to determine whether the previously issued auditor's report is still appropriate before such report is reissued.

## Definitions

.07 For purposes of generally accepted auditing standards, the following terms have the meanings attributed as follows:

**Date of the auditor's report.** The date that the auditor dates the report on the financial statements, in accordance with section 700.<sup>2</sup> (Ref: par. .A14)

**Date of the financial statements.** The date of the end of the latest period covered by the financial statements.

**Subsequent events.** Events occurring between the date of the financial statements and the date of the auditor's report.

**Subsequently discovered facts.** Facts that become known to the auditor after the date of the auditor's report that, had they been known to the auditor at that date, may have caused the auditor to revise the auditor's report.

.08 Reference to *audited financial statements* in this section means *the financial statements, together with the auditor's report thereon*.

## Requirements

### Subsequent Events

.09 The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence that all subsequent events that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions. (Ref: par. .A2–.A3)

.10 The auditor should perform the procedures required by paragraph .09 so that they cover the period from the date of the financial statements to the date of the auditor's report or as near as practicable thereto. The auditor should

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<sup>2</sup> Paragraph .41 of section 700.



take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which should include the following: (Ref: par. .A4-.A5 and .A8-.A10)

- a. Obtaining an understanding of any procedures that management has established to ensure that subsequent events are identified
- b. Inquiring of management and, when appropriate, those charged with governance about whether any subsequent events have occurred that might affect the financial statements (Ref: par. .A6)
- c. Reading minutes, if any, of the meetings of the entity's owners, management, and those charged with governance that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available (Ref: par. .A4 and .A7)
- d. Reading the entity's latest subsequent interim financial statements, if any

.11 If, as a result of the procedures performed as required by paragraphs .09-.10, the auditor identifies subsequent events that require adjustment of, or disclosure in, the financial statements, the auditor should determine whether each such event is appropriately reflected in the financial statements in accordance with the applicable financial reporting framework.

### **Subsequently Discovered Facts That Become Known to the Auditor Before the Report Release Date**

.12 The auditor is not required to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, if a subsequently discovered fact becomes known to the auditor before the report release date,<sup>3</sup> the auditor should

- a. discuss the matter with management and, when appropriate, those charged with governance.
- b. determine whether the financial statements need revision and, if so, inquire how management intends to address the matter in the financial statements.

.13 If management revises the financial statements, the auditor should perform the audit procedures necessary in the circumstances on the revision. The auditor also should either (Ref: par. .A11-.A16)

- a. date the auditor's report as of a later date; extend the audit procedures referred to in paragraphs .09-.10 to the new date of the auditor's report on the revised financial statements; and request written representations from management as of the new date of the auditor's report, in accordance with the requirements of section 580, *Written Representations*, or
- b. include an additional date in the auditor's report on the revised financial statements that is limited to the revision (that is, dual-date the auditor's report for that revision), thereby indicating that the auditor's procedures subsequent to the original date of the auditor's report are limited solely to the revision of the financial statements described in the relevant note to the financial statements. In this circumstance, the auditor should request written

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<sup>3</sup> The term *report release date* is defined in paragraph .06 of section 230, *Audit Documentation*.

representations from management as of the additional date in the auditor's report about whether

- i. any information has come to management's attention that would cause management to believe that any of the previous representations should be modified.
- ii. any other events have occurred subsequent to the date of the financial statements that would require adjustment to, or disclosure in, those financial statements.

**.14** If management does not revise the financial statements in circumstances when the auditor believes they need to be revised, the auditor should modify the opinion (express a qualified opinion or an adverse opinion), as required by section 705, *Modifications to the Opinion in the Independent Auditor's Report*. (Ref: par. .A17)

### **Subsequently Discovered Facts That Become Known to the Auditor After the Report Release Date**

**.15** If a subsequently discovered fact becomes known to the auditor after the report release date, the auditor should (Ref: par. .A18–.A20)

- a. discuss the matter with management and, when appropriate, those charged with governance.
- b. determine whether the financial statements need revision and, if so, inquire how management intends to address the matter in the financial statements.

**.16** If management revises the financial statements, the auditor should

- a. apply the requirements of paragraph .13.
- b. if the audited financial statements (before revision) have been made available to third parties, assess whether the steps taken by management are timely and appropriate to ensure that anyone in receipt of those financial statements is informed of the situation, including that the audited financial statements are not to be relied upon. If management does not take the necessary steps, the auditor should apply the requirements of paragraph .18. (Ref: par. .A21–.A22)
- c. if the auditor's opinion on the revised financial statements differs from the opinion the auditor previously expressed, disclose the following matters in an emphasis-of-matter or other-matter paragraph, in accordance with section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*:
  - i. The date of the auditor's previous report
  - ii. The type of opinion previously expressed
  - iii. The substantive reasons for the different opinion
  - iv. That the auditor's opinion on the revised financial statements is different from the auditor's previous opinion

**.17** If management does not revise the financial statements in circumstances when the auditor believes they need to be revised, then

- a. if the audited financial statements have not been made available to third parties, the auditor should notify management and those

charged with governance—unless all of those charged with governance are involved in managing the entity<sup>4</sup>—not to make the audited financial statements available to third parties before the necessary revisions have been made and a new auditor's report on the revised financial statements has been provided. If the audited financial statements are, nevertheless, subsequently made available to third parties without the necessary revisions, the auditor should apply the requirements of paragraph .17b.

- b. if the audited financial statements have been made available to third parties, the auditor should assess whether the steps taken by management are timely and appropriate to ensure that anyone in receipt of the audited financial statements is informed of the situation, including that the audited financial statements are not to be relied upon. If management does not take the necessary steps, the auditor should apply the requirements of paragraph .18. (Ref: par. .A21–.A22)

.18 If management does not take the necessary steps to ensure that anyone in receipt of the audited financial statements is informed of the situation, as provided by paragraphs .16b or .17b, the auditor should notify management and those charged with governance—unless all of those charged with governance are involved in managing the entity<sup>5</sup>—that the auditor will seek to prevent future reliance on the auditor's report. If, despite such notification, management or those charged with governance do not take the necessary steps, the auditor should take appropriate action to seek to prevent reliance on the auditor's report. (Ref: par. .A23–.A26)

### **Predecessor Auditor's Reissuance of the Auditor's Report in Comparative Financial Statements (Ref: par. .A27–.A28)**

#### ***Predecessor Auditor's Report Reissued (Ref: par. .A29–.A30)***

.19 Before reissuing a previously issued auditor's report on financial statements that are to be presented on a comparative basis with audited financial statements of a subsequent period, the predecessor auditor should perform the following procedures to determine whether the previously issued auditor's report is still appropriate:

- a. Read the financial statements of the subsequent period to be presented on a comparative basis
- b. Compare the prior period financial statements that the predecessor auditor reported on with the financial statements of the subsequent period to be presented on a comparative basis
- c. Inquire of, and request written representations from, management of the former client, at or near the date of reissuance, about whether
  - i. any information has come to management's attention that would cause management to believe that any of the previous representations should be modified

<sup>4</sup> Paragraph .14 of section 260, *The Auditor's Communication With Those Charged With Governance*.

<sup>5</sup> Paragraph .14 of section 260.

- ii. any events have occurred subsequent to the date of the latest prior period financial statements reported on by the predecessor auditor that would require adjustment to, or disclosure in, those financial statements
- d. Obtain a representation letter from the successor auditor stating whether the successor auditor's audit revealed any matters that, in the successor auditor's opinion, might have a material effect on, or require disclosure in, the financial statements reported on by the predecessor auditor

**.20** If, in performing the procedures in paragraph .19, a subsequently discovered fact becomes known to the predecessor auditor, then

- a. the predecessor auditor should apply the requirements of paragraph .15.
- b. if management revises the financial statements and the predecessor auditor plans to issue a new auditor's report on the revised financial statements, the predecessor auditor should apply the requirements of paragraph .16.
- c. if management revises the financial statements and the predecessor auditor does not plan to issue a new auditor's report on the revised financial statements, or if management does not revise the financial statements in circumstances when the predecessor auditor believes they need to be revised, the predecessor auditor should assess the steps taken by management, as required by paragraph .17b.

## Application and Other Explanatory Material

### Scope of This Section (Ref: par. .01)

**.A1** When audited financial statements are included in other documents subsequent to their issuance, the auditor may have additional responsibilities to consider, such as legal or regulatory requirements involving private placement offerings, exempt public offerings (including offerings pursuant to Securities and Exchange Commission [SEC] Rule 144A), or other offerings of securities to the public in jurisdictions outside the United States. Section 720, *Other Information in Documents Containing Audited Financial Statements*, may be applied, adapted as necessary in the circumstances, to such other documents. Section 925, *Filings With the U.S. Securities and Exchange Commission Under the Securities Act of 1933*, addresses the auditor's responsibilities in connection with financial statements of a nonissuer included in a registration statement filed with the SEC under the Securities Act of 1933, as amended.

### Subsequent Events (Ref: par. .09–.11)

**.A2** The period between the date of the financial statements and the date of the auditor's report may vary from a relatively short period to one or more months. Some phases of the audit will be performed during this period, whereas other phases will be substantially completed on or before the date of the financial statements. As an audit approaches completion, the auditor is not expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions. New information, however, may be inconsistent with the audit evidence obtained, in which case the auditor is required to determine what modifications or additions to

audit procedures are necessary to resolve the matter and consider the effect of the matter, if any, on other aspects of the audit.<sup>6</sup>

**.A3** Depending on the auditor's risk assessment, the audit procedures required by paragraphs .09–.10 may include procedures necessary to obtain sufficient appropriate audit evidence involving the review or testing of accounting records or transactions occurring between the date of the financial statements and the date of the auditor's report. The audit procedures required by paragraphs .09–.10 are in addition to procedures that the auditor may perform for other purposes that, nevertheless, may provide evidence about subsequent events (for example, to obtain audit evidence for account balances as of the date of the financial statements, such as cut-off procedures or procedures regarding subsequent receipts of accounts receivable).

**.A4** Paragraph .10 stipulates certain audit procedures that the auditor is required to perform pursuant to paragraph .09. However, the subsequent events procedures that the auditor performs may depend on the information that is available and, in particular, the manner in which the accounting records have been maintained and the extent to which information has been prepared since the date of the financial statements. When interim financial statements (whether for internal or external purposes) or minutes of meetings of management or those charged with governance have not been prepared, relevant audit procedures may take the form of inspection of available books and records.

**.A5** In addition to the audit procedures required by paragraphs .09–.10, the auditor may consider it necessary and appropriate to read the entity's latest available budgets, cash flow forecasts, and other related management reports for periods after the date of the financial statements. Paragraphs .A6–.A10 provide guidance on additional matters that the auditor may consider in the course of performing subsequent events procedures.

***Inquiry (Ref: par. .10b)***

**.A6** In inquiring of management and, when appropriate, those charged with governance about whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire about the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters:

- Whether new commitments, borrowings, or guarantees have been entered into
- Whether sales or acquisitions of assets have occurred or are planned
- Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned
- Whether any assets have been appropriated by the government or destroyed (for example, by fire or flood)
- Whether there have been any developments regarding contingencies
- Whether any unusual accounting adjustments have been made or are contemplated

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<sup>6</sup> Paragraph .10 of section 500, *Audit Evidence*.

- Whether any events have occurred or are likely to occur that will bring into question the appropriateness of accounting policies used in the financial statements, as would be the case, for example, if such events call into question the validity of the going concern assumption
- Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements
- Whether any events have occurred that are relevant to the recoverability of assets

**Reading Minutes (Ref: par. .10c)***Considerations Specific to Governmental Entities*

.A7 In audits of governmental entities, the auditor may, in performing the requirement in paragraph .10c, read the official records of relevant proceedings of the legislative or governing body, or other relevant regulatory or oversight body, and inquire about matters addressed in proceedings for which official records are not yet available.

**Inquiries of Legal Counsel**

.A8 Section 501, *Audit Evidence—Specific Considerations for Selected Items*, addresses the auditor's responsibility to seek direct communication with the entity's legal counsel concerning litigation, claims, and assessments through the date of the auditor's report.

**Written Representations**

.A9 Section 580 requires the auditor to request that management and, when appropriate, those charged with governance provide written representations as of the date of the auditor's report that all events occurring subsequent to the date of the financial statements, and for which the applicable financial reporting framework requires adjustment or disclosure, have been adjusted or disclosed.<sup>7</sup> The auditor may consider whether written representations covering particular subsequent events or significant matters disclosed to the auditor in the performance of the audit procedures required by paragraphs .09–.10 may be necessary to support other audit evidence to obtain sufficient appropriate audit evidence.

.A10 The applicable financial reporting framework may require management to evaluate subsequent events through the date the financial statements are issued or available to be issued and to disclose the date through which subsequent events were evaluated in the financial statements. In most cases, this will result in the date that management discloses as the date through which management has evaluated subsequent events being the same date as the auditor's report. This is because section 700 requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that the audit documentation has been reviewed; that all the statements that comprise the financial statements, including related notes, have been prepared; and that management has asserted

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<sup>7</sup> Paragraph .18 of section 580, *Written Representations*.

that they have taken responsibility for those financial statements.<sup>8</sup> Also, the auditor is concerned with subsequent events that require adjustment of, or disclosure in, the financial statements through the date of the auditor's report or as near as practicable thereto. Therefore, management's representations concerning events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure are required to be made as of the date of the auditor's report on the financial statements.<sup>9</sup> To align the date disclosed by management in the financial statements, the representation letter date, and the auditor's report date, the auditor may discuss the dating requirements with management and may also include, in the terms of the audit engagement,<sup>10</sup> that management will not date the subsequent event disclosure earlier than the date of the representation letter (also the date of the auditor's report).

### **Subsequently Discovered Facts That Become Known to the Auditor Before the Report Release Date (Ref: par. .12–.14)**

#### ***Dating the Auditor's Report on the Revised Financial Statements (Ref: par. .13)***

**.A11** The auditor has two methods available for dating the auditor's report when the financial statements are revised after the original date of the auditor's report. The auditor may include an additional date limited to the revision (that is, dual-date the auditor's report for that revision) or date the auditor's report as of a later date. In the former instance, the auditor's responsibility for events occurring subsequent to the original date of the auditor's report is limited to the specific event described in the relevant note to the financial statements. In the latter instance, the auditor's responsibility for subsequent events extends to the new date of the auditor's report on the revised financial statements.

**.A12** Generally, when the revision of the financial statements is specifically limited to the effects of the specific event described in the relevant note to the financial statements, the auditor may decide to limit the audit procedures to that revision, as provided by paragraph .13b. Even when the financial statements are revised and disclosure of the revision is made, the auditor is not precluded from extending the audit procedures referred to in paragraphs .09–.10 to the new date of the auditor's report on the revised financial statements, as provided by paragraph .13a.

**.A13** When, in the circumstances described in paragraph .13b, the auditor includes an additional date limited to the revision (a dual date), the original date of the auditor's report on the financial statements prior to their subsequent revision by management remains unchanged because this date informs the reader about when the auditor obtained sufficient appropriate audit evidence with respect to those financial statements prior to their subsequent revision. However, an additional date is included in the auditor's report to inform users that the auditor's procedures subsequent to the original date of the auditor's report were limited to the subsequent revision of the financial statements. The following is an illustration of such wording:

(Date of auditor's report), except as to note Y, which is as of (date of completion of audit procedures limited to revision described in note Y).

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<sup>8</sup> Paragraph .41 of section 700.

<sup>9</sup> Paragraph .20 of section 580.

<sup>10</sup> Paragraph .A23 of section 210, *Terms of Engagement*.

**.A14** As discussed in paragraph .A10, section 700 requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements.<sup>11</sup> When management revises the financial statements and the auditor reports on the revised financial statements, the new date (or the dual date) included in the auditor's report cannot be earlier than the date on which the auditor carried out the audit procedures necessary in the circumstances on the revision, including that the documentation has been reviewed and management has prepared and asserted that they have taken responsibility for the revised financial statements.

#### ***Updated Written Representations***

**.A15** Section 580 requires the date of the written representations to be as of the date of the auditor's report on the financial statements.<sup>12</sup> If management revises the financial statements and, in accordance with paragraph .13a, the auditor dates the auditor's report on the revised financial statements as of a later date, written representations from management are required as of the later date to comply with section 580. The auditor may request management to provide a new representation letter or may agree with management on a form of written representations that update the written representations previously provided by addressing whether there are any changes to such written representations and, if so, what they are. An updated written representation letter may be in the form of the representations required by paragraph .13b when the auditor dual-dates the auditor's report for the revision.

#### ***Unaudited Events***

**.A16** To prevent the financial statements from being misleading, management may revise the financial statements by disclosing an event that arose after the original date of the auditor's report. When such event is included in a separate financial statement note that is labeled as unaudited (for example, when the event is captioned "Event (Unaudited) Subsequent to the Date of the Independent Auditor's Report"), the auditor is not required to perform any procedures on the revision, and the auditor's report carries the original date of the auditor's report.

*Considerations Specific to Governmental Entities (Ref: par. .14)*

**.A17** In audits of governmental entities in which management does not revise the financial statements, the actions taken in accordance with paragraph .14 may also include reporting separately to the legislative or governing body, or other relevant regulatory or oversight body, on the implications of the subsequent event for the financial statements and the auditor's report and, if applicable, for the entity's internal control over financial reporting and compliance with law or regulation.

### **Subsequently Discovered Facts That Become Known to the Auditor After the Report Release Date (Ref: par. .15–.18)**

#### ***Auditor's Responsibility After the Report Release Date (Ref: par. .15)***

**.A18** New information may come to the auditor's attention that, had such information been known to the auditor at the date of the auditor's report, may have caused the auditor to revise the auditor's report. When such information

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<sup>11</sup> Paragraph .41 of section 700.

<sup>12</sup> Paragraph .20 of section 580.



becomes known to the auditor after the report release date, the requirements in paragraphs .15–.18 apply, even if the auditor has withdrawn or been discharged.

**.A19** Because of the variety of conditions that might be encountered, the specific procedures or actions to be taken in a particular case may vary somewhat in light of the circumstances. For example, in determining whether the financial statements need revision, as required by paragraph .15b, the auditor may consider, in addition to the requirements of the applicable financial reporting framework, whether the auditor believes there are persons currently relying or likely to rely on the financial statements who would attach importance to the subsequently discovered facts. Consideration may be given, among other things, to the issuance of audited financial statements for a subsequent period, the time elapsed since the financial statements were issued and the auditor's report released, and any legal implications.

**.A20** Section 708, *Consistency of Financial Statements*, addresses the auditor's evaluation of the consistency of the financial statements, including changes to previously issued financial statements, and the effect of that evaluation on the auditor's report.

#### ***Revision of Financial Statements by Management (Ref: par. .16b and .17b)***

**.A21** The steps taken by management to ensure that anyone in receipt of the audited financial statements is informed of the situation, including that the audited financial statements are not to be relied upon, depend on the circumstances. Management's steps may include the following:

- Notification to anyone who is known to be relying or who is likely to rely on the financial statements and the auditor's report that they are not to be relied upon and that revised financial statements, together with a new auditor's report, will be issued. This may be necessary when the issuance of revised financial statements and a new auditor's report is not imminent.
- Issuing, as soon as practicable, revised financial statements with appropriate disclosure of the matter.
- Issuing the subsequent period's financial statements with appropriate disclosure of the matter. This may be appropriate when issuance of the subsequent period's audited financial statements is imminent.

#### ***Considerations Specific to Governmental Entities***

**.A22** For audits performed under *Government Auditing Standards*, additional requirements exist, such as those pertaining to the evaluation of the timeliness and appropriateness of management's disclosure and actions to determine and correct misstatements in previously issued financial statements, reporting on the revised financial statements, and reporting directly to appropriate officials when management does not take the necessary steps.

#### ***Auditor Action to Seek to Prevent Reliance on the Auditor's Report (Ref: par. .18)***

**.A23** If management made the audited financial statements available to third parties despite the auditor's notification not to do so, or if the auditor believes that management or those charged with governance have failed to take the necessary steps to prevent reliance on the auditor's report on the previously issued audited financial statements despite the auditor's prior notification that the auditor will take action to seek to prevent such reliance, the auditor's course

of action depends upon the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

**.A24** The actions that the auditor may take to seek to prevent reliance on the auditor's report may depend upon the degree of certainty of the auditor's knowledge that persons or entities exist who are currently relying or who will rely on the audited financial statements, and who would attach importance to the information, and the auditor's ability as a practical matter to communicate with them. In addition to seeking legal advice, the auditor may consider taking the following steps to the extent applicable:

- Notify management and those charged with governance that the auditor's report is not to be relied upon.
- Notify regulatory agencies having jurisdiction over the entity that the auditor's report is not to be relied upon, including a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure.
- Notify anyone known to the auditor to be relying on the financial statements that the auditor's report is not to be relied upon. In some instances, it will not be practicable for the auditor to give appropriate individual notification to stockholders or investors at large whose identities are unknown to the auditor; notification to a regulatory agency having jurisdiction over the entity will usually be the only practical means for the auditor to provide appropriate disclosure, together with a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure.

**.A25** Depending on the circumstances, if the auditor is able to determine that the financial statements need revision, the auditor's notification to anyone in receipt of the audited financial statements may, if permitted by law, regulation, and relevant ethical requirements,

- include a description of the nature of the matter and of its effect on the financial statements, avoiding comments concerning the conduct or motives of any person.
- describe the effect that the matter would have had on the auditor's report if it had been known to the auditor at the date of the report and had not been reflected in the financial statements.

**.A26** If the auditor was not able to determine whether the financial statements need revision, the notification to anyone in receipt of the audited financial statements may indicate that information became known to the auditor and that, if the information is true, the auditor believes that the auditor's report is not to be relied upon. The specific matter need not be detailed in the notification.

### **Predecessor Auditor's Reissuance of the Auditor's Report in Comparative Financial Statements (Ref: par. .19–.20)**

**.A27** An auditor may be requested by management or those charged with governance to furnish additional copies of the auditor's report after the report release date. Providing additional copies of the auditor's report is not a report reissuance. In such cases, the auditor has no responsibility to make further investigation or inquiry about events that may have occurred during the period between the date of the auditor's report and the date of the release of the additional copies.

**.A28** Additional responsibilities relating to the reissuance of a previously issued auditor's report in connection with financial statements of a nonissuer included in a registration statement filed with the SEC under the Securities Act of 1933, as discussed in paragraph .A1, are addressed in section 925.

***Predecessor Auditor's Report Reissued***

**.A29** A predecessor auditor may be requested to reissue the auditor's report by a former client when prior period financial statements audited by the predecessor auditor are to be presented on a comparative basis with audited financial statements of a subsequent period. A predecessor auditor's knowledge of the current affairs of the former client is limited in the absence of a continuing relationship. Accordingly, a predecessor auditor may be in a position to reissue the report if the predecessor auditor is able to make satisfactory arrangements with the former client to perform this service and if the predecessor auditor complies with paragraph .19 to determine whether the previous auditor's report is still appropriate. A predecessor auditor is not required to reissue the auditor's report. Either the current form or manner of presentation of the financial statements of the prior period or one or more events might make a predecessor auditor's previous report inappropriate.

**.A30** Section 700 addresses the auditor's responsibilities when the auditor is engaged to audit and report on a revision to prior period financial statements audited by the predecessor auditor.<sup>13</sup> It also addresses the auditor's responsibilities when the predecessor auditor's report will not be presented.<sup>14</sup>

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<sup>13</sup> Paragraph .A52 of section 700A.

<sup>14</sup> Paragraph .54 of section 700A.

## AU-C Section 260

### ***The Auditor's Communication With Those Charged With Governance***

Source: SAS No. 122; SAS No. 123; SAS No. 125; SAS No. 128.

Effective for audits of financial statements for periods ending on or after December 15, 2012.

#### **Introduction**

##### **Scope of This Section**

.01 This section addresses the auditor's responsibility to communicate with those charged with governance in an audit of financial statements. Although this section applies regardless of an entity's governance structure or size, particular considerations apply when all of those charged with governance are involved in managing an entity. This section does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role.

.02 This section is written in the context of an audit of financial statements but may also be applied, adapted as necessary in the circumstances, to audits of other historical financial information when those charged with governance have a responsibility to oversee the preparation and fair presentation of the other historical financial information.

.03 Recognizing the importance of effective two-way communication in an audit of financial statements, this section provides an overarching framework for the auditor's communication with those charged with governance and identifies some specific matters to be communicated. Additional matters to be communicated are identified in other AU-C sections (see the exhibit, "Requirements to Communicate With Those Charged With Governance in Other AU-C Sections"). In addition, section 265, *Communicating Internal Control Related Matters Identified in an Audit*, establishes specific requirements regarding the communication of significant deficiencies and material weaknesses in internal control the auditor has identified during the audit to those charged with governance. Further matters not required by generally accepted auditing standards (GAAS) may be required to be communicated by agreement with those charged with governance or management or in accordance with external requirements. Nothing in this section precludes the auditor from communicating any other matters to those charged with governance.

##### **Effective Date**

.04 This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

##### **Objectives**

.05 The objectives of the auditor are to

- a. communicate clearly with those charged with governance the responsibilities of the auditor regarding the financial statement audit and an overview of the planned scope and timing of the audit.
- b. obtain from those charged with governance information relevant to the audit.
- c. provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process.
- d. promote effective two-way communication between the auditor and those charged with governance. (Ref: par. .A1–.A5)

## Definitions

**.06** For purposes of GAAS, the following terms have the meanings attributed as follows:

**Management.** The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance; for example, executive members of a governance board or an owner-manager.

**Those charged with governance.** The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel; for example, executive members of a governance board or an owner-manager.

## Requirements

### Those Charged With Governance

**.07** The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. (Ref: par. .A6–.A9)

#### ***Communication With the Audit Committee or Other Subgroup of Those Charged With Governance***

**.08** If the auditor communicates with a subgroup of those charged with governance, such as the audit committee or an individual, the auditor should determine whether the auditor also needs to communicate with the governing body. (Ref: par. .A10–.A12)

#### ***When All of Those Charged With Governance Are Involved in Managing the Entity***

**.09** In some cases, all of those charged with governance are involved in managing the entity; for example, a small business in which a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this section are communicated with a person(s) with management responsibilities and that person(s) also has governance responsibilities, the matters need not be communicated again with the same person(s) in that person's governance role. These matters are noted in paragraph .14. The auditor should, nonetheless, be satisfied that communication with person(s)

with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.

## **Matters to Be Communicated**

### ***The Auditor's Responsibilities With Regard to the Financial Statement Audit***

**.10** The auditor should communicate with those charged with governance the auditor's responsibilities with regard to the financial statement audit, including that (Ref: par. .A13–.A17)

- a. the auditor is responsible for forming and expressing an opinion about whether the financial statements that have been prepared by management, with the oversight of those charged with governance, are prepared, in all material respects, in accordance with the applicable financial reporting framework.
- b. the audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

### ***Planned Scope and Timing of the Audit***

**.11** The auditor should communicate with those charged with governance an overview of the planned scope and timing of the audit. (Ref: par. .A18–.A22)

### ***Significant Findings or Issues From the Audit***

**.12** The auditor should communicate with those charged with governance (Ref: par. .A23)

- a. the auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. When applicable, the auditor should (Ref: par. .A24–.A25)
  - i. explain to those charged with governance why the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework not to be most appropriate to the particular circumstances of the entity and
  - ii. determine that those charged with governance are informed about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.
- b. significant difficulties, if any, encountered during the audit. (Ref: par. .A26)
- c. disagreements with management, if any. (Ref: par. .A28)
- d. other findings or issues, if any, arising from the audit that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their responsibility to oversee the financial reporting process. (Ref: par. .A27)

### ***Uncorrected Misstatements***

**.13** The auditor should communicate with those charged with governance (Ref: par. .A29–.A30)

- a. uncorrected misstatements accumulated by the auditor and the effect that they, individually or in the aggregate, may have on

the opinion in the auditor's report. The auditor's communication should identify material uncorrected misstatements individually. The auditor should request that uncorrected misstatements be corrected.

- b. the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

*When Not All of Those Charged With Governance Are Involved in Management*

**.14** Unless all of those charged with governance are involved in managing the entity, the auditor also should communicate

- a. material, corrected misstatements that were brought to the attention of management as a result of audit procedures. (Ref: par. .A31)
- b. significant findings or issues, if any, arising from the audit that were discussed, or the subject of correspondence, with management. (Ref: par. .A32)
- c. the auditor's views about significant matters that were the subject of management's consultations with other accountants on accounting or auditing matters when the auditor is aware that such consultation has occurred.
- d. written representations the auditor is requesting. (Ref: par. .A33)

## The Communication Process

### *Establishing the Communication Process*

**.15** The auditor should communicate with those charged with governance the form, timing, and expected general content of communications. (Ref: par. .A34–.A38)

### *Forms of Communication*

**.16** The auditor should communicate in writing with those charged with governance significant findings or issues from the audit (see paragraphs .12–.14) if, in the auditor's professional judgment, oral communication would not be adequate. This communication need not include matters that arose during the course of the audit that were communicated with those charged with governance and satisfactorily resolved. (Ref: par. .A39–.A41)

### *Restricted Use*

**.17** When the auditor communicates matters in accordance with this section in writing, the communication is considered a by-product report.<sup>1</sup> Accordingly, the auditor should indicate in the communication that it is intended solely for the information and use of those charged with governance and, if appropriate, management, and is not intended to be, and should not be, used by anyone other than these specified parties.

### *Timing of Communications*

**.18** The auditor should communicate with those charged with governance on a timely basis. (Ref: par. .A42–.A43)

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<sup>1</sup> Paragraphs .06c and .07 of section 905, *Alert That Restricts the Use of the Auditor's Written Communication*. [Footnote amended, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125.]

**Adequacy of the Communication Process**

**.19** The auditor should evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor should evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence and should take appropriate action. (Ref: par. .A44–.A46)

**Documentation**

**.20** When matters required to be communicated by this section have been communicated orally, the auditor should include them in the audit documentation, including when and to whom they were communicated.<sup>2</sup> When matters have been communicated in writing, the auditor should retain a copy of the communication as part of the audit documentation. (Ref: par. .A47)

**Application and Other Explanatory Material****Objectives*****The Role of Communication (Ref: par. .05)***

**.A1** This section focuses primarily on communications from the auditor to those charged with governance. Nevertheless, effective two-way communication is important in assisting

- the auditor and those charged with governance in understanding matters related to the audit in context and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity.
- the auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events.
- those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

**.A2** Although the auditor is responsible for communicating specific matters in accordance with this section, management also has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of this responsibility. Similarly, management's communication of these matters to those charged with governance does not relieve the auditor of the responsibility to also communicate them. However, communication of these matters by management may affect the form or timing of the auditor's communication.

**.A3** Clear communication of specific matters required to be communicated by GAAS is an integral part of every audit. However, GAAS do not require the auditor to perform procedures specifically to identify other significant matters to communicate with those charged with governance.

<sup>2</sup> Paragraphs .08–.12 and .A8 of section 230, *Audit Documentation*.



*Legal or Regulatory Restrictions on Communicating With Those Charged With Governance (Ref: par. .05)*

**.A4** Law or regulation may restrict the auditor's communication of certain matters with those charged with governance. For example, law or regulation may specifically prohibit a communication or other action that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider obtaining legal advice.

**.A5** In certain circumstances, the auditor may be required to report to a regulatory or enforcement body certain matters that have been communicated with those charged with governance. For example, *Government Auditing Standards* requires auditors to report fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse directly to such parties in certain circumstances.

**Those Charged With Governance (Ref: par. .07)**

**.A6** Governance structures vary by entity, reflecting influences such as size and ownership characteristics. For example:

- In some entities, those charged with governance hold positions (for example, company directors) that are integral parts of the entity's legal structure. For other entities, a body that is not part of the entity is charged with governance, as with some government agencies.
- In some cases, some or all of those charged with governance also have management responsibilities. In others, those charged with governance and management are different people.
- Parties charged with governance of governmental entities may include members or staff of a legislative oversight committee, oversight bodies, or other parties contracting for the audit.

**.A7** In most entities, governance is the collective responsibility of a governing body, such as a board of directors; a supervisory board; partners; proprietors; a committee of management; trustees; or equivalent persons. In some smaller entities, however, one person may be charged with governance, such as the owner-manager, when there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup, such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities.

**.A8** Such diversity means that it is not possible for this section to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Also, in some cases, the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances. An example of this is entities in which the governance structures are not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. When the appropriate person(s) with whom to communicate is not clearly identifiable, the auditor and the engaging party may need to discuss and agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes obtained in accordance with section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material*

*Misstatement*, is relevant. The appropriate person(s) with whom to communicate may vary depending on the matter to be communicated.

**.A9** Section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, includes specific matters to be communicated by group auditors with those charged with governance.<sup>3</sup> When the entity being audited is a component of a group, the appropriate person(s) with whom to communicate is dependent on the nature of the matter to be communicated and the terms of the engagement.

### **Communication With the Audit Committee or Other Subgroup of Those Charged With Governance (Ref: par. .08)**

**.A10** When considering communicating with a subgroup of those charged with governance, the auditor may take into account matters such as

- the respective responsibilities of the subgroup and the governing body.
- the nature of the matter to be communicated.
- relevant legal or regulatory requirements.
- whether the subgroup (a) has the authority to take action regarding the information communicated and (b) can provide further information and explanations the auditor may need.
- whether the auditor is aware of potential conflicts of interest between the subgroup and other members of the governing body.

**.A11** When deciding whether there is also a need to communicate information, in full or in summary form, with the governing body, the auditor may be influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. The auditor may make explicit in the terms of the engagement that the auditor retains the right to communicate directly with the governing body.

**.A12** Audit committees (or similar subgroups with different names) exist in many entities. Although the specific authority and functions of audit committees may differ, communication with the audit committee, when one exists, is a key element in the auditor's communication with those charged with governance. Good governance principles suggest that

- the auditor has access to the audit committee as necessary.
- the chair of the audit committee and, when relevant, the other members of the audit committee meet with the auditor periodically.
- the audit committee meets with the auditor without management present at least annually, unless prohibited by law or regulation.

## **Matters to Be Communicated**

### **The Auditor's Responsibilities With Regard to the Financial Statement Audit (Ref: par. .10)**

**.A13** The auditor's responsibilities with regard to the financial statement audit are often included in the engagement letter or other suitable form of

<sup>3</sup> Paragraphs .45–.48 of section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.

written agreement that documents the terms of the engagement. Providing those charged with governance with a copy of that engagement letter or other suitable form of written agreement may be an appropriate way to communicate with them that

- the auditor is responsible for performing the audit in accordance with GAAS and that the audit is designed to obtain reasonable, rather than absolute, assurance about whether the financial statements as a whole are free from material misstatement.
- an audit of financial statements 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 entity's internal control over financial reporting.
- the auditor is responsible for communicating significant matters related to the financial statement audit that are, in the auditor's professional judgment, relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. GAAS do not require the auditor to design procedures for the purpose of identifying other matters to communicate with those charged with governance.
- when applicable, the auditor is also responsible for communicating particular matters required by law or regulation, by agreement with the entity, or by additional requirements applicable to the engagement.

*Independence (Ref: par. .10)*

**.A14** GAAS require independence for all audits. Relevant matters to consider in reaching a conclusion about independence include circumstances or relationships that create threats to auditor independence and the related safeguards that have been applied to eliminate those threats or reduce them to an acceptable level. Comprehensive material on threats to independence and safeguards, including application to specific situations, is set forth in the AICPA's "Conceptual Framework for Independence" (ET sec. 1.210.010). [Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

**.A15** Although the auditor's report affirms the auditor's independence, in certain situations, the auditor may determine that it is appropriate to communicate with those charged with governance circumstances or relationships (for example, financial interests, business or family relationships, or nonaudit services provided or expected to be provided) that, in the auditor's professional judgment, may reasonably be thought to bear on independence, and to which the auditor gave significant consideration, in reaching the conclusion that independence has not been impaired.

**.A16** It may be particularly appropriate to communicate with those charged with governance those circumstances or relationships discussed in paragraph .A15 in audits of public interest entities. In addition to entities subject to Securities and Exchange Commission reporting requirements, all of the entities described in the definition of public interest entities in ET section 0.400, *Definitions*, are considered to be public interest entities.

[Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

**.A17** The form and timing of communications regarding independence may be affected by the entity's governance structure and whether a formal subgroup, such as an audit committee, exists. In situations in which all of those charged with governance are involved in managing the entity, the auditor may determine that those charged with governance have been informed of relevant facts regarding the auditor's independence through their management activities or through other means, such as the engagement letter. This is particularly likely when the entity is owner-managed and the auditor's firm has little involvement with the entity beyond a financial statement audit.

***Planned Scope and Timing of the Audit (Ref: par. .11)***

**.A18** Care is required when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly when some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable. Certain factors described in paragraph .A39 may be relevant in determining the nature and extent of this communication.

**.A19** Communication regarding the planned scope and timing of the audit may assist

- those charged with governance to discuss issues of risk and materiality with the auditor;
- those charged with governance to understand better the consequences of the auditor's work and to identify any areas in which they may request the auditor to undertake additional procedures; and
- the auditor to understand better the entity and its environment.

**.A20** Matters communicated may include the following:

- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error
- The auditor's approach to internal control relevant to the audit including, when applicable, whether the auditor will express an opinion on the effectiveness of internal control over financial reporting
- The application of materiality in the context of an audit, as discussed in section 320, *Materiality in Planning and Performing an Audit*
- If the entity has an internal audit function, how the auditor and the internal auditors can work together in a constructive and complementary manner, including any planned use of the work of the internal audit function in obtaining audit evidence and the nature and extent of any planned use of internal auditors to provide direct assistance.

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

**.A21** Other planning matters that may be appropriate to discuss with those charged with governance include

- the views of those charged with governance about the following matters:

## General Principles and Responsibilities

- The appropriate person(s) in the entity's governance structure with whom to communicate
  - The allocation of responsibilities between those charged with governance and management
  - The entity's objectives and strategies and the related business risks that may result in material misstatements
  - Matters those charged with governance consider as warranting particular attention during the audit and any areas for which they request additional procedures to be undertaken
  - Significant communications with regulators
  - Other matters those charged with governance believe are relevant to the audit of the financial statements
- the attitudes, awareness, and actions of those charged with governance concerning (a) the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or the possibility of fraud.
  - the actions of those charged with governance in response to developments in law, accounting standards, corporate governance practices, and other related matters.
  - the actions of those charged with governance in response to previous communications with the auditor.

**.A22** Although communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing, and extent of procedures necessary to obtain sufficient appropriate audit evidence.

**Significant Findings From the Audit (Ref: par. .12)**

**.A23** The communication of significant findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

**Qualitative Aspects of the Entity's Significant Accounting Practices (Ref: par. .12a)**

**.A24** Financial reporting frameworks ordinarily allow for the entity to make accounting estimates and judgments about accounting policies and financial statement disclosures. Open and constructive communication about qualitative aspects of the entity's significant accounting practices may include comment on the acceptability of significant accounting practices. The appendix, "Qualitative Aspects of Accounting Practices," identifies matters that may be included in this communication.

**.A25** Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. In communicating with those charged with governance about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's

conclusions regarding the reasonableness of those estimates, the auditor may consider communicating

- the nature of significant assumptions,
- the degree of subjectivity involved in the development of the assumptions, and
- the relative materiality of the items being measured to the financial statements as a whole.

*Significant Difficulties Encountered During the Audit (Ref: par. .12b)*

**.A26** Significant difficulties encountered during the audit may include matters such as

- significant delays in management providing required information.
- an unnecessarily brief time within which to complete the audit.
- extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- the unavailability of expected information.
- restrictions imposed on the auditor by management.
- management's unwillingness to provide information about management's plans for dealing with the adverse effects of the conditions or events that lead the auditor to believe there is substantial doubt about the entity's ability to continue as a going concern.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.

*Other Findings or Issues*

**.A27** The auditor may become aware that the entity is subject to an audit requirement that is not encompassed in the terms of the engagement. The communication to those charged with governance that an audit conducted in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements may be necessary if, for example, an entity engages an auditor to perform an audit of its financial statements in accordance with GAAS and the auditor becomes aware that by law, regulation, or contractual agreement the entity also is required to have an audit performed in accordance with one or more of the following:

- a. *Government Auditing Standards*
- b. *OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations*
- c. Other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides

*Disagreements With Management (Ref: par. .12c)*

**.A28** Discussions with those charged with governance include any disagreements with management that arose during the audit, regardless of whether they were satisfactorily resolved, about matters that, individually or in the aggregate, could be significant to the entity's financial statements or the auditor's report. Disagreements with management may occasionally arise over, among other things, the application of accounting principles to the entity's specific transactions and events and the basis for management's judgments about accounting estimates. Disagreements may also arise regarding the scope of the audit, disclosures to be included in the entity's financial statements, and the wording of the auditor's report. For purposes of this section, disagreements

do not include differences of opinion based on incomplete facts or preliminary information that are later resolved.

*Uncorrected Misstatements (Ref: par. .13)*

**.A29** The auditor is not required to accumulate misstatements that the auditor believes are trivial.<sup>4</sup> When there are a large number of individually immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.

**.A30** The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, taking into account the size and nature of the misstatement judged in the surrounding circumstances, and possible implications with regard to future financial statements.

*Corrected Misstatements (Ref: par. .14a)*

**.A31** The auditor also may communicate corrected immaterial misstatements, such as frequently recurring immaterial misstatements that may indicate a particular bias in the preparation of the financial statements.

*Significant Findings or Issues Discussed or Subject to Correspondence With Management (Ref: par. .14b)*

**.A32** Significant findings or issues discussed, or the subject of correspondence, with management may include matters such as

- business conditions affecting the entity and business plans and strategies that may affect the risks of material misstatement.
- discussions or correspondence in connection with the initial or recurring engagement of the auditor including, among other matters, any discussions or correspondence regarding accounting practices or the application of auditing standards.

*Written Representations (Ref: par. .14d)*

**.A33** The auditor may provide those charged with governance with a copy of management's written representations.

## The Communication Process

*Establishing the Communication Process (Ref: par. .15)*

**.A34** Clear communication of the following helps establish the basis for effective two-way communication:

- The auditor's responsibilities (paragraphs .10 and .A12–.A15)
- An overview of the planned scope and timing of the audit (paragraphs .11 and .A16–.A20)
- The expected general content of communications

**.A35** Matters that may also contribute to effective two-way communication include discussion of

- the purpose of communications. When the purpose is clear, the auditor and those charged with governance are in a better position to have a mutual understanding of relevant issues and the expected actions arising from the communication process.

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<sup>4</sup> Paragraph .05 of section 450, *Evaluation of Misstatements Identified During the Audit*.

- the form in which communications will be made.
- the person(s) on the audit team and among those charged with governance who will communicate regarding particular matters.
- the auditor's expectation that communication will be two-way and that those charged with governance will communicate with the auditor matters they consider relevant to the audit. Such matters might include (a) strategic decisions that may significantly affect the nature, timing, and extent of audit procedures; (b) the suspicion or the detection of fraud; or (c) concerns with the integrity or competence of senior management.
- the process for taking action and reporting back on matters communicated by the auditor.
- the process for taking action and reporting back on matters communicated by those charged with governance.

**.A36** The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor's view of the significance of matters to be communicated. Difficulty in establishing effective two-way communication may indicate that the communication between the auditor and those charged with governance is not adequate for the purpose of the audit (see paragraph .A44).

#### *Communication With Management*

**.A37** Many matters may be discussed with management in the ordinary course of an audit, including matters to be communicated with those charged with governance in accordance with this section. Such discussions recognize management's executive responsibility for the conduct of the entity's operations and, in particular, management's responsibility for the preparation and fair presentation of the financial statements.

**.A38** Before communicating matters with those charged with governance, the auditor may discuss them with management unless that is inappropriate. For example, it may not be appropriate to discuss with management questions of management's competence or integrity. In addition to recognizing management's responsibility, these initial discussions may clarify facts and issues and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with appropriate individuals within the function before communicating with those charged with governance. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

#### **Forms of Communication (Ref: par. .16)**

**.A39** Effective communication may involve formal presentations and written reports as well as less formal communications, including discussions. The auditor may communicate matters other than those identified in paragraph .16 either orally or in writing. Written communications may include an engagement letter that is provided to those charged with governance.

**.A40** In addition to the significance of a particular matter, the form of communication (for example, whether to communicate orally or in writing, the extent of detail or summarization in the communication, and whether to communicate in a formal or informal manner) may be affected by factors such as

- whether the matter has been satisfactorily resolved.
- whether management has previously communicated the matter.



- the size, operating structure, control environment, and legal structure of the entity being audited.
- legal or regulatory requirements that may require a written communication with those charged with governance.
- the expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- the amount of ongoing contact and dialogue the auditor has with those charged with governance.
- whether there have been significant changes in the membership of a governing body.
- in the case of an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.

**.A41** When a significant matter is discussed with an individual member of those charged with governance, such as the chair of an audit committee, it may be appropriate for the auditor to summarize the matter in later communications so that all of those charged with governance have full and balanced information.

***Timing of Communications (Ref: par. .18)***

**.A42** The appropriate timing for communications will vary with the circumstances of the engagement. Considerations include the significance and nature of the matter and the action expected to be taken by those charged with governance. The auditor may consider communicating

- planning matters early in the audit engagement and, for an initial engagement, as part of the terms of the engagement.
- significant difficulties encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor in overcoming the difficulties or if the difficulties are likely to lead to a modified opinion.

**.A43** Other factors that may be relevant to the timing of communications include

- the size, operating structure, control environment, and legal structure of the entity being audited.
- any legal obligation to communicate certain matters within a specified timeframe.
- the expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- the time at which the auditor identifies certain matters (for example, timely communication of a material weakness to enable appropriate remedial action to be taken).
- whether the auditor is auditing both general purpose and special purpose financial statements.

***Adequacy of the Communication Process (Ref: par. .19)***

**.A44** The auditor need not design specific procedures to support the evaluation of the two-way communication between the auditor and those charged

with governance. Rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Such observations may include

- the appropriateness and timeliness of actions taken by those charged with governance in response to matters communicated by the auditor. When significant findings or issues raised in previous communications have not been dealt with effectively, it may be appropriate for the auditor to inquire about why appropriate action has not been taken and to consider raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.
- the apparent openness of those charged with governance in their communications with the auditor.
- the willingness and capacity of those charged with governance to meet with the auditor without management present.
- the apparent ability of those charged with governance to fully comprehend matters raised by the auditor, such as the extent to which those charged with governance probe issues and question recommendations made to them.
- difficulty in establishing with those charged with governance a mutual understanding of the form, timing, and expected general content of communications.
- when all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities as well as their management responsibilities.

**.A45** As discussed in paragraph .A1, effective two-way communication assists both the auditor and those charged with governance. Further, section 315 identifies participation by those charged with governance, including their interaction with the internal audit function (if any) and external auditors, as an element of the entity's control environment. Inadequate two-way communication may indicate an unsatisfactory control environment, which will influence the auditor's assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

**.A46** If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, the auditor may take actions such as the following:

- Modifying the auditor's opinion on the basis of a scope limitation
- Obtaining legal advice about the consequences of different courses of action
- Communicating with third parties (for example, a regulator) or a higher authority in the governance structure that is outside the entity, such as the owners of a business (for example, shareholders in a general meeting), or the responsible government agency for certain governmental entities
- Withdrawing from the engagement when withdrawal is possible under applicable law or regulation

**Documentation (Ref: par. .20)**

**.A47** Documentation of oral communication may include a copy of minutes prepared by the entity as part of the audit documentation if those minutes are an appropriate record of the communication.

.A48

## Appendix—Qualitative Aspects of Accounting Practices

The communication required by paragraph .12a and discussed in paragraphs .A24–.A25 may include such matters as the following:

### Accounting Policies

- The appropriateness of the accounting policies to the particular circumstances of the entity, considering the need to balance the cost of providing information with the likely benefit to users of the entity's financial statements (when acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant policies as well as information on accounting policies used by similar entities)
- The initial selection of, and changes in, significant accounting policies, including the application of new accounting pronouncements (the communication may include the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity, and the timing of a change in accounting policies with regard to expected new accounting pronouncements)
- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative material or consensus)
- The effect of the timing of transactions in relation to the period in which they are recorded

### Accounting Estimates

- For items for which estimates are significant, issues discussed in section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, including the following examples:
  - Management's identification of accounting estimates
  - Management's process for making accounting estimates
  - Risks of material misstatement
  - Indicators of possible management bias
  - Disclosure of estimation uncertainty in the financial statements

### Financial Statement Disclosures

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (for example, disclosures related to revenue recognition, going concern, subsequent events, and contingency issues)
- The overall neutrality, consistency, and clarity of the disclosures in the financial statements

**Related Matters**

- The potential effect on the financial statements of significant risks and exposures and uncertainties, such as pending litigation, that are disclosed in the financial statements
- The extent to which the financial statements are affected by unusual transactions, including nonrecurring amounts recognized during the period, and the extent to which such transactions are separately disclosed in the financial statements
- The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets (the communication may explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements)
- The selective correction of misstatements (for example, correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings)

.A49

## Exhibit—Requirements to Communicate With Those Charged With Governance in Other AU-C Sections

Requirements for the auditor to communicate with those charged with governance are included in other AU-C sections. This section does not change the requirements in

- a. paragraph .17 of section 210, *Terms of Engagement*
- b. paragraphs .21, .38c(i), and .39–.41 of section 240, *Consideration of Fraud in a Financial Statement Audit*
- c. paragraphs .14, .18, and .21–.23 of section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*
- d. paragraph .11 of section 265, *Communicating Internal Control Related Matters Identified in an Audit*
- e. paragraph .27 of section 550, *Related Parties*
- f. paragraphs .10b–c, .12a, .15a, .17a, and .18 of section 560, *Subsequent Events and Subsequently Discovered Facts*
- g. paragraph .19 of section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
- h. paragraphs .45–.48 of section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*
- i. paragraphs .12, .14, .20, and .29 of section 705, *Modifications to the Opinion in the Independent Auditor's Report*
- j. paragraph .09 of section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*
- k. paragraphs .08, .12, .15, and .18 of section 720, *Other Information in Documents Containing Audited Financial Statements*
- l. paragraph .06 of section 730, *Required Supplementary Information*
- m. paragraphs .23–.28 of section 930, *Interim Financial Information*
- n. paragraphs .36–.37 of section 935, *Compliance Audits*

[Revised: September 2012, to reflect conforming changes necessary due to the issuance of SAS No. 126.]

**AU-C Section 940*****An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements***

Source: SAS No. 130.

Effective for integrated audits for periods ending on or after December 15, 2016.

**Introduction****Scope of This Section**

.01 This section establishes requirements and provides guidance that applies only when an auditor is engaged to perform an audit of internal control over financial reporting (ICFR) that is integrated with an audit of financial statements (*integrated audit*). (Ref: par. .A1)

.02 Generally accepted auditing standards (GAAS) are written in the context of an audit of financial statements but are to be adapted as necessary in the circumstances when applied to an audit of ICFR that is integrated with an audit of financial statements.<sup>1</sup> This section includes special considerations related to performing an integrated audit.

**Effective Date**

.03 This section is effective for integrated audits for periods ending on or after December 15, 2016.

**Objectives**

.04 The objectives of the auditor in an audit of ICFR are to

- a. obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment about the effectiveness of ICFR (*as of date*) and
- b. express an opinion on the effectiveness of ICFR in a written report, and communicate with management and those charged with governance as required by this section, based on the auditor's findings. (Ref: par. .A2–.A4)

**Definitions**

.05 For purposes of GAAS, the following terms have the meanings attributed as follows:

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<sup>1</sup> Paragraph .02 of section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.

**Audit of ICFR.** An audit of the design and operating effectiveness of an entity's ICFR.

**Control objective.** The aim or purpose of specified controls. Control objectives address the risks that the controls are intended to mitigate. In the context of ICFR, a control objective generally relates to a relevant assertion for a significant class of transactions, account balance, or disclosure and addresses the risk that the controls in a specific area will not provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented, or detected and corrected, on a timely basis.

**Criteria.** The benchmarks used to measure or evaluate the subject matter. (Ref: par. .A5)

**Detective control.** A control that has the objective of detecting and correcting errors or fraud that have already occurred that could result in a misstatement of the financial statements.

**Internal control over financial reporting (ICFR).** A process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with the applicable financial reporting framework and includes those policies and procedures that

- i. pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity;
- ii. provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with the applicable financial reporting framework, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and
- iii. provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

ICFR has inherent limitations. ICFR is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. ICFR also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented, or detected and corrected, on a timely basis by ICFR. (Ref: par. .A6–.A7)

**Management's assessment about ICFR.** Management's conclusion about the effectiveness of the entity's ICFR, based on suitable and available criteria. Management's assessment is included in management's report on ICFR. (Ref: par. .A8)

**Preventive control.** A control that has the objective of preventing errors or fraud that could result in a misstatement of the financial statements.



## Requirements

### Preconditions for the Audit of ICFR

**.06** Section 210, *Terms of Engagement*, requires the auditor to establish whether the preconditions for an audit are present.<sup>2</sup> In an audit of ICFR, the auditor should

- a. obtain the agreement of management that it acknowledges and understands its responsibility for
  - i. designing, implementing, and maintaining effective ICFR.
  - ii. evaluating the effectiveness of the entity's ICFR using suitable and available criteria.
  - iii. providing management's assessment about ICFR in a report that accompanies the auditor's report (see paragraph .55).
  - iv. supporting its assessment about the effectiveness of the entity's ICFR with sufficient evaluations and documentation.
  - v. providing the auditor with
    - (1) access to all information of which management is aware that is relevant to management's assessment of ICFR, such as records, documentation, and other matters;
    - (2) additional information that the auditor may request from management for the purpose of the audit of ICFR; and
    - (3) unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence. (Ref: par. .A9–.A12)
- b. determine that the as of date corresponds to the balance sheet date (or period ending date) of the period covered by the financial statements. (Ref: par. .A13)

**.07** The auditor should evaluate the effectiveness of the entity's ICFR using the same suitable and available criteria used by management for its assessment. (Ref: par. .A14–.A17)

### Requesting a Written Assessment

**.08** In accordance with paragraph .06a(iii), the auditor should request from management a written assessment about the effectiveness of the entity's ICFR. Management's refusal to provide a written assessment represents a scope limitation, and the auditor should apply the requirements in paragraphs .74–.77.

### Integrating the Audit of ICFR With the Financial Statement Audit

**.09** Although the objectives of an audit of ICFR and an audit of financial statements are not the same, the auditor should plan and perform the integrated audit to achieve their respective objectives simultaneously. The auditor should design tests of controls

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<sup>2</sup> Paragraph .06 of section 210, *Terms of Engagement*.

- a. to obtain sufficient appropriate audit evidence to support the auditor's opinion on ICFR as of the date specified in management's assessment about ICFR and
- b. to obtain sufficient appropriate audit evidence to support the auditor's control risk assessments for purposes of the audit of financial statements. (Ref: par. .A18–.A19)

.10 If the auditor is engaged to audit the effectiveness of an entity's ICFR for a period of time, the requirements and guidance in this section should be modified accordingly, and the auditor should integrate the audit of ICFR with an audit of financial statements covering the same period of time.

.11 The auditor should consider the effect of the results of the financial statement auditing procedures on the auditor's risk assessments and the testing necessary to conclude on the operating effectiveness of a control.

.12 If, during the audit of ICFR, the auditor identifies a deficiency in ICFR, the auditor should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an acceptably low level. See paragraphs .52–.54 for requirements on evaluating the effects of findings, including those from the financial statement audit, when forming an opinion on the effectiveness of ICFR.

.13 When concluding on the effectiveness of controls for the purpose of the financial statement audit, the auditor should evaluate the results of any additional tests of controls performed by the auditor to achieve the objective related to expressing an opinion on the entity's ICFR. (Ref: par. .A20)

## Planning the Audit of ICFR

.14 In accordance with section 300, *Planning an Audit*, the auditor should establish an overall audit strategy that sets the scope, timing, and direction of the audit of ICFR and that guides the development of the audit plan.<sup>3</sup> (Ref: par. .A21)

### Role of Risk Assessment

.15 The auditor should focus more attention on areas of higher risk. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the entity's ICFR and the amount of attention that would be devoted to that area. In addition, an entity's ICFR is less likely to prevent, or detect and correct, a misstatement caused by fraud than a misstatement caused by error. It is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements. (Ref: par. .A22–.A24)

### Addressing the Risk of Fraud

.16 The auditor should evaluate whether the entity's controls sufficiently address identified risks of material misstatement due to fraud and the risk of management override of other controls. (Ref: par. .A25)

.17 Section 240, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud.<sup>4</sup> If the auditor

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<sup>3</sup> Paragraph .07 of section 300, *Planning an Audit*.

<sup>4</sup> Paragraph .23 of section 240, *Consideration of Fraud in a Financial Statement Audit*.

identifies deficiencies in controls designed to prevent, or detect and correct, misstatements caused by fraud during the audit of ICFR, the auditor should take into account those deficiencies when developing the response to risks of material misstatement during the financial statement audit.<sup>5</sup>

### ***Using the Work of Internal Auditors or Others***

**.18** The external auditor should obtain an understanding of the work of the internal audit function and others sufficient to identify those activities related to the effectiveness of ICFR that are relevant to planning and performing the audit of ICFR. (Ref: par. .A26)

**.19** The external auditor should evaluate the extent to which the external auditor will use the work of internal auditors or others to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor. When using the work of internal auditors, section 610, *Using the Work of Internal Auditors*, is applicable. When the external auditor plans to use the work of others in obtaining audit evidence or to provide direct assistance in the audit of ICFR, the external auditor should apply the requirements in section 610 as if others were internal auditors. (Ref: par. .A27–.A30)

### ***Materiality***

**.20** The auditor should use the same materiality for planning and performing the audit of ICFR and the financial statement audit. (Ref: par. .A31)

### ***Using a Top-Down Approach***

**.21** The auditor should use a top-down approach to the audit of ICFR to select the controls to test. (Ref: par. .A32–.A33)

### ***Entity-Level Controls***

**.22** The auditor should identify and test those entity-level controls that are important to the auditor's conclusion about whether the entity has effective ICFR. (Ref: par. .A34–.A37)

### ***Evaluating the Components of ICFR***

**.23** In an integrated audit, the auditor should evaluate the components of ICFR and determine whether

- a. the components are present and functioning in the design, implementation, and operation of ICFR, and
- b. the components are operating together in an integrated manner to achieve the entity's financial reporting objectives. (Ref: par. .A38–.A48)

### ***Period-End Financial Reporting Process***

**.24** Because of its importance to financial reporting and to the integrated audit, the auditor should evaluate the period-end financial reporting process, which includes the following:

- a. Procedures used to enter transaction totals into the general ledger
- b. Procedures related to the selection and application of accounting policies

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<sup>5</sup> See paragraphs .28–.33 of section 240.

- c. Procedures used to initiate, authorize, record, and process journal entries in the general ledger
- d. Procedures used to record recurring and nonrecurring adjustments to the financial statements
- e. Procedures for preparing financial statements (Ref: par. .A49)

**.25** As part of evaluating the period-end financial reporting process, the auditor should assess

- a. the inputs, procedures performed, and outputs of the processes the entity uses to produce its financial statements;
- b. the extent of IT involvement in the period-end financial reporting process;
- c. who participates from management;
- d. the locations involved in the period-end financial reporting process;
- e. the types of adjusting and consolidating entries; and
- f. the nature and extent of the oversight of the process by management and those charged with governance.

***Identifying Significant Classes of Transactions, Account Balances, and Disclosures, and Their Relative Assertions***

**.26** The auditor should identify significant classes of transactions, account balances, and disclosures, and their relevant assertions. To identify significant classes of transactions, account balances, and disclosures, and their relevant assertions, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. (Ref: par. .A50–.A52)

**.27** As part of identifying significant classes of transactions, account balances, and disclosures, and their relevant assertions, the auditor should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. (Ref: par. .A53–.A54)

**.28** When an entity has components, the auditor should identify significant classes of transactions, account balances, and disclosures, and their relevant assertions, based on the group financial statements. (Ref: par. .A55)

***Understanding Likely Sources of Misstatement***

**.29** To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should

- a. understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, recorded, processed, and reported.
- b. identify the points within the entity's processes at which a misstatement, including a misstatement due to fraud, could arise that, individually or in combination with other misstatements, would be material (for example, points at which information is initiated, transferred, or otherwise modified).
- c. identify the controls that management has implemented to address these potential misstatements.
- d. identify the controls that management has implemented over the prevention; or timely detection and correction, of unauthorized acquisition, use, or disposition of the entity's assets that could

have a material effect on the financial statements. (Ref: par. .A56–.A57)

**.30** Because of the degree of judgment necessary, the auditor should either directly perform the procedures that achieve the requirements in paragraph .29 or supervise the work of the internal auditors or others who provide direct assistance to the auditor.

**.31** The auditor should understand how IT affects the entity's flow of transactions and, as required by section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, how the entity has responded to risks arising from IT.<sup>6</sup> (Ref: par. .A58)

### **Selecting Controls to Test**

**.32** The auditor should identify and test those controls that are important to the auditor's conclusion about whether the entity's controls sufficiently address the assessed risk of material misstatement to each relevant assertion. (Ref: par. .A59–.A60)

## **Testing Controls**

### **Evaluating Design Effectiveness**

**.33** The auditor should evaluate the design effectiveness of controls by determining whether the entity's controls, if operated as prescribed by persons possessing the necessary authority and competence to perform them effectively, satisfy the entity's control objectives, and can effectively prevent, or detect and correct, misstatements caused by errors or fraud that could result in material misstatements in the financial statements. (Ref: par. .A61–.A62)

### **Testing Operating Effectiveness**

**.34** The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. (Ref: par. .A63–.A64)

### **Relationship of Risk to the Evidence to Be Obtained**

**.35** As the risk associated with the control being tested increases, the sufficiency and appropriateness of evidence that the auditor obtains should also increase. (Ref: par. .A65–.A68)

**.36** The auditor should obtain evidence about the effectiveness of selected controls for each relevant assertion. The auditor is not responsible for obtaining sufficient appropriate audit evidence to support an opinion about the effectiveness of each individual control. (Ref: par. .A69–.A75)

**.37** To obtain evidence about whether a selected control is effective, the auditor should test the control.

**.38** When the auditor identifies control deviations, the auditor should determine the effect of the deviations on the auditor's assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control. (Ref: par. .A76)

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<sup>6</sup> Paragraph .22 of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

*Timing and Extent of Tests of Controls*

**.39** To express an opinion on ICFR as of a point in time, the auditor should obtain evidence that ICFR has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the entity's financial statements. The auditor should balance performing the tests of controls closer to the as of date with the need to test controls over a sufficient period of time to obtain sufficient appropriate audit evidence of operating effectiveness. (Ref: par. .A77–.A80)

*Rollforward Procedures*

**.40** When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, the auditor should determine what additional evidence concerning the operation of the controls for the remaining period is necessary. (Ref: par. .A81–.A82)

***Special Considerations for Subsequent Years' Audits***

**.41** In subsequent years' audits, the auditor should incorporate knowledge obtained during past audits performed by the auditor of the entity's ICFR into the decision-making process for determining the nature, timing, and extent of testing necessary. (Ref: par. .A83–.A85)

**.42** The auditor should vary the nature, timing, and extent of testing of controls from period to period to introduce unpredictability into the testing and respond to changes in circumstances. (Ref: par. .A86)

**Identifying Deficiencies in ICFR**

**.43** The auditor should determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in ICFR. (Ref: par. .A87)

***Determination of Whether Material Weaknesses Exist as of the Date Specified in Management's Assessment About ICFR***

**.44** For purposes of forming an opinion on the effectiveness of ICFR, the auditor should evaluate the severity of each deficiency in ICFR to determine whether the deficiency, individually or in combination, is a material weakness as of the date specified in management's assessment about ICFR. In performing such evaluation, the auditor should determine whether deficiencies that affect the same significant class of transactions, account balance, or disclosure; relevant assertion; or component of ICFR, collectively result in a material weakness. (Ref: par. .A88–.A94)

**.45** The auditor should evaluate the effect of compensating controls when determining whether a deficiency, or combination of deficiencies, in ICFR is a material weakness as of the date specified in management's assessment about ICFR. The auditor should test the operating effectiveness of such compensating controls to determine whether they operate at a level of precision that would prevent, or detect and correct, a material misstatement. (Ref: par. .A95)

**.46** If the auditor initially determines that a deficiency, or a combination of deficiencies, in ICFR is not a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion. (Ref: par. .A96)

***Determination of Whether Significant Deficiencies Exist During the Integrated Audit***

.47 The auditor should evaluate the severity of each deficiency in ICFR to determine whether the deficiency, individually or in combination, is a significant deficiency. In performing such evaluation, the auditor should determine whether deficiencies that affect the same significant class of transactions, account balance, or disclosure; relevant assertion; or component of ICFR collectively result in a significant deficiency. (Ref: par. .A97–.A98)

**Subsequent Events**

.48 The auditor should inquire of management and, when appropriate, those charged with governance, about whether there were any changes in ICFR or conditions that might significantly affect ICFR subsequent to the as of date but before the date of the auditor's report. To obtain additional information about changes in ICFR or other conditions that might significantly affect the effectiveness of the entity's ICFR, the auditor should inquire about and read, for this subsequent period, the following: (Ref: par. .A99)

- a. Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period
- b. Reports regarding deficiencies issued by other independent auditors
- c. Regulatory agency reports on the entity's ICFR
- d. Information about the effectiveness of the entity's ICFR obtained through other engagements performed for the entity by the auditor

.49 If, as a result of the subsequent events procedures, the auditor obtains knowledge about a material weakness that existed as of the date specified in management's assessment about ICFR, the auditor should issue an adverse opinion, as required by paragraph .68. The auditor should also follow paragraph .72 if management's assessment about ICFR states that ICFR is effective. If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the entity's ICFR as of the date specified in management's assessment about ICFR, the auditor should disclaim an opinion. The auditor should disclaim an opinion on management's disclosures about corrective actions taken by the entity, if any. (Ref: par. .A100)

.50 If the auditor obtains knowledge about conditions that did not exist at the as of date but arose subsequent to that date and before the release of the auditor's report and such subsequent information has a material effect on the entity's ICFR, the auditor should include in the auditor's report an emphasis-of-matter paragraph directing the reader's attention to the subsequently discovered fact and its effects as disclosed in management's report or an other-matter paragraph describing the subsequently discovered fact and its effects. (Ref: par. .A101)

.51 The auditor has no responsibility to keep informed of events subsequent to the date of the auditor's report; however, the auditor should respond appropriately to facts that become known to the auditor after the date of the auditor's report that, had they been known to the auditor at that date, may have caused the auditor to revise the auditor's report.

## Concluding Procedures

### *Forming an Opinion*

**.52** The auditor should form an opinion on the effectiveness of ICFR by evaluating evidence obtained from all sources, including

- a. the auditor's testing of controls for the ICFR audit,
- b. any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements,
- c. misstatements detected during the financial statement audit, and
- d. any identified deficiencies.

**.53** As part of evaluating evidence obtained from all sources, the auditor should review reports issued during the year by the internal audit function (or similar functions) that address controls related to ICFR and evaluate deficiencies identified in those reports.

**.54** In addition to evaluating the findings from the auditor's testing of controls for the audit of ICFR, the auditor should evaluate the effect of the findings of the substantive procedures performed in the audit of financial statements on the effectiveness of ICFR. This evaluation should include, at a minimum,

- a. the risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud;
- b. findings with respect to noncompliance with laws and regulations;
- c. findings with respect to related party transactions and complex or unusual transactions;
- d. indications of management bias in making accounting estimates and selecting accounting principles; and
- e. the nature and extent of misstatements detected by substantive procedures.

**.55** After forming an opinion on the effectiveness of the entity's ICFR, the auditor should evaluate management's report, which will accompany the auditor's report, to determine whether it contains the following:

- a. A statement regarding management's responsibility for ICFR
- b. A description of the subject matter of the audit (for example, controls over the preparation of the entity's financial statements in accordance with accounting principles generally accepted in the United States of America)
- c. An identification of the criteria against which ICFR is measured
- d. Management's assessment about ICFR
- e. A description of the material weakness(es), if any
- f. The date as of which management's assessment about ICFR is made

**.56** If the auditor determines that any required element of management's report is incomplete or improperly presented, the auditor should request management to revise its report. (Ref: par. .A102)

### *Obtaining Written Representations*

**.57** In an audit of ICFR, the auditor should obtain written representations from management

- a. acknowledging management's responsibility for establishing and maintaining effective ICFR;



- b. stating that management has performed an assessment of the effectiveness of the entity's ICFR and specifying the criteria;
- c. stating that management did not use the auditor's procedures performed during the integrated audit as part of the basis for management's assessment about ICFR;
- d. stating management's assessment about the effectiveness of the entity's ICFR based on the criteria as of a specified date;
- e. stating that management has disclosed to the auditor all deficiencies in the design or operation of ICFR, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses;
- f. describing any fraud resulting in a material misstatement to the entity's financial statements and any other fraud that does not result in a material misstatement to the entity's financial statements, but involves senior management or management or other employees who have a significant role in the entity's ICFR;
- g. stating whether the significant deficiencies and material weaknesses identified and communicated to management and those charged with governance during previous engagements pursuant to paragraph .59 have been resolved and specifically identifying any that have not; and
- h. stating whether there were, subsequent to the date being reported on, any changes in ICFR or other conditions that might significantly affect ICFR, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses (Ref: par. .A103)

**.58** If management does not provide the written representations required by paragraph .57, the auditor should apply the requirements in paragraph .73. (Ref: par. .A104)

### ***Communicating ICFR-Related Matters***

**.59** The auditor should communicate in writing to management and those charged with governance significant deficiencies and material weaknesses identified during the integrated audit, including those that were remediated during the integrated audit and those that were previously communicated but have not yet been remediated. (Ref: par. .A105–.A107)

**.60** If the auditor concludes that the oversight of the entity's financial reporting and ICFR by the audit committee (or similar subgroups with different names) is ineffective, the auditor should communicate that conclusion in writing to the board of directors or other similar governing body.

**.61** The written communications referred to in paragraphs .59–.60 should be made by the report release date, which is the date the auditor grants the entity permission to use the auditor's report. For a governmental entity, if such written communications would be publicly available prior to management's report on ICFR, the entity's financial statements, and the auditor's report thereon, the auditor is not required to make the written communications by the report release date. In that circumstance, the written communications should be made as soon as practicable, but no later than 60 days following the report release date. (Ref: par. .A108–.A109)

**.62** The auditor should communicate in writing to management all deficiencies identified during the integrated audit on a timely basis, but no later than 60 days following the report release date, and inform those charged with

governance when such a communication was or is expected to be made. In making the written communication referred to in this paragraph, the auditor is not required to communicate those deficiencies that are not material weaknesses or significant deficiencies that were included in previous written communications, regardless of whether those communications were made by the auditor, internal auditors, or others within the organization. (Ref: par. .A110–.A112)

**.63** Because the integrated audit does not provide the auditor with reasonable assurance that the auditor has identified all deficiencies less severe than a material weakness, the auditor should not issue a report stating that no such deficiencies were identified during the integrated audit. Also, because the auditor issues a report that expresses an opinion on the effectiveness of the entity's ICFR, the auditor should not issue a report indicating that no material weaknesses were identified during the integrated audit.

### Reporting on ICFR

**.64** The auditor's report on the audit of ICFR should be in writing and should include the following elements:

- a. A title that includes the word *independent* to clearly indicate that it is the report of an independent auditor
- b. An addressee as required by the circumstances of the engagement
- c. An introductory paragraph that includes the following:
  - i. Identification of the entity whose ICFR has been audited
  - ii. A statement that the entity's ICFR has been audited
  - iii. Identification of the as of date
  - iv. Identification of the criteria against which ICFR is measured
- d. A section with the heading "Management's Responsibility for Internal Control Over Financial Reporting" that includes the following:
  - i. A statement that management is responsible for designing, implementing, and maintaining effective ICFR
  - ii. A statement that management is responsible for its assessment about the effectiveness of ICFR
  - iii. A reference to management's report on ICFR
- e. A section with the heading "Auditor's Responsibility" that includes the following:
  - i. A statement that the auditor's responsibility is to express an opinion on the entity's ICFR based on the audit
  - ii. A statement that the audit was conducted in accordance with auditing standards generally accepted in the United States of America (Ref: par. .A113)
  - iii. A statement that such standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective ICFR was maintained in all material respects
  - iv. A description of the audit by stating that
    - (1) an audit of ICFR involves performing procedures to obtain audit evidence about whether a material weakness exists

- (2) the procedures selected depend on the auditor's judgment, including the assessment of the risks that a material weakness exists
  - (3) an audit includes obtaining an understanding of ICFR and testing and evaluating the design and operating effectiveness of ICFR based on the assessed risk
- v. A statement about whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the audit opinion
- f. A section with the heading "Definition and Inherent Limitations of Internal Control Over Financial Reporting" or other appropriate heading that includes the following:
  - i. A definition of ICFR (the auditor should use the same description of the entity's ICFR as management uses in its report)
  - ii. A paragraph stating that because of inherent limitations, ICFR may not prevent, or detect and correct, misstatements and that projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate
- g. A section with the heading "Opinion" that includes the auditor's opinion on whether the entity maintained, in all material respects, effective ICFR as of the specified date, based on the criteria
- h. The manual or printed signature of the auditor's firm
- i. The city and state where the auditor practices
- j. The date of the auditor's report, as required by paragraph .66

**.65** If the auditor issues a separate report on ICFR, the auditor should add the following paragraph, in an other-matter paragraph with an appropriate heading, in accordance with section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*, to the auditor's report on the financial statements:

We also have audited, in accordance with auditing standards generally accepted in the United States of America, [entity name]'s internal control over financial reporting as of December 31, 20X8, based on [identify criteria] and our report dated [date of report, which should be the same as the date of the report on the financial statements] expressed [include nature of opinion].

The auditor also should add the following other-matter paragraph to the report on ICFR:

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of [entity name] and our report dated [date of report, which should be the same as the date of the report on ICFR] expressed [include nature of opinion]. (Ref: par. .A114–.A116)

### **Report Date**

**.66** The auditor should date the report on ICFR no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the auditor's opinion, including evidence that the audit documentation has been reviewed. Because the audit of ICFR is integrated with the audit of the financial

statements, when issuing separate reports on the entity's financial statements and on ICFR, the dates of the reports should be the same.

### Report Modifications

**.67** The auditor should modify the report on ICFR if any of the following conditions exist:

- a.* One or more material weaknesses exist.
- b.* Elements of management's report are incomplete or improperly presented.
- c.* There is a limitation on the scope of the engagement. (Ref: par. .A117)
- d.* The auditor decides to refer to the report of a component auditor as the basis, in part, for the auditor's own opinion.
- e.* There is other information contained in management's report.

### Adverse Opinions

**.68** If there are deficiencies that, individually or in combination, result in one or more material weaknesses as of the date specified in management's assessment about ICFR, the auditor should express an adverse opinion on the entity's ICFR, unless there is a limitation on the scope of the engagement. (Ref: par. .A118–.A119)

**.69** When ICFR is not effective because one or more material weaknesses exist, the auditor's report should include

- a.* the definition of a material weakness and
- b.* a statement that one or more material weaknesses have been identified and an identification of the material weaknesses described in management's assessment about ICFR. (Ref: par. .A120)

**.70** If one or more material weaknesses have not been included in management's report accompanying the auditor's report, the auditor's report should be modified to state that one or more material weaknesses have been identified but not included in management's report. Additionally, the auditor's report should include a description of each material weakness not included in management's report. The auditor's description should include specific information about the nature of each material weakness and its actual and potential effect on the presentation of the entity's financial statements issued during the existence of the weakness. In this case, the auditor also should communicate, in writing, to those charged with governance that one or more material weaknesses were not disclosed or identified as a material weakness in management's report. If one or more material weaknesses have been included in management's report but the auditor concludes that the disclosure of such material weaknesses is not fairly presented in all material respects, the auditor's report should describe this conclusion as well as the information necessary to fairly describe each material weakness.

**.71** The auditor should determine the effect an adverse opinion on ICFR has on the auditor's opinion on the financial statements. Additionally, the auditor should disclose, in an other-matter paragraph or as part of the paragraph that identifies the material weakness, whether the auditor's opinion on the financial statements was affected by the material weakness. (Ref: par. .A121)

***Elements of Management's Report Are Incomplete or Improperly Presented***

.72 If the auditor determines that any required element of management's report, as described in paragraph .55, is incomplete or improperly presented and management does not revise its report, the auditor should modify the report on ICFR to include an other-matter paragraph describing the reasons for this determination. If the auditor determines that the required disclosure about one or more material weaknesses is not fairly presented in all material respects, the auditor should apply the requirements in paragraph .70.

***Scope Limitations***

.73 If, after accepting the integrated audit engagement, there is a limitation on the scope of the engagement with respect to ICFR, the auditor should withdraw from the integrated audit engagement or disclaim an opinion on ICFR and consider the implications on the financial statement audit.

.74 When a scope limitation arises because management refuses to furnish a written assessment about the effectiveness of ICFR, the auditor should withdraw from the integrated audit engagement. When withdrawal is not possible under applicable law or regulation, the auditor should disclaim an opinion on ICFR and consider the implications on the financial statement audit. (Ref: par. A122)

.75 When disclaiming an opinion because of a scope limitation, the auditor should state that the auditor does not express an opinion on the effectiveness of ICFR and the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of ICFR, as described in paragraph .64e; to do so might overshadow the disclaimer. (Ref: par. A123–A124)

.76 When the auditor disclaims an opinion but has concluded that one or more material weaknesses exist, the auditor's report also should include

- a. the definition of a material weakness and
- b. a description of any material weaknesses identified in the entity's ICFR. This description should address the requirements in paragraph .69 and should provide the users of the report with specific information about the nature of any material weakness and its actual and potential effect on the presentation of the entity's financial statements issued during the existence of the weakness.

The auditor also should apply the requirements in paragraph .71. (Ref: par. A125)

.77 If the auditor concludes that the auditor cannot express an opinion because there has been a limitation on the scope of the audit, the auditor should communicate, in writing, to management and those charged with governance that the audit of ICFR cannot be satisfactorily completed.

***Making Reference to a Component Auditor and Assuming Responsibility for the Work of a Component Auditor***

.78 When an entity includes one or more components, the group engagement partner should evaluate whether the group engagement team will be able to obtain sufficient appropriate audit evidence through the group engagement team's work or use of the work of component auditors (that is, through assuming responsibility for the work of component auditors or making reference to the audit of ICFR of a component auditor in the auditor's report) to act as the auditor of the ICFR over the group financial statements and report as such on the ICFR over the group financial statements, as required by section 600,

*Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors).*<sup>7</sup> (Ref: par. .A126)

.79 As required by section 600, the group engagement partner should determine whether to make reference to a component auditor in the report on the ICFR over the group financial statements.<sup>8</sup> Reference to the audit of a component auditor in the auditor's report on the ICFR over the group financial statements should not be made unless

- a. the engagement partner has determined that the component auditor has performed an audit of the component's ICFR in accordance with the relevant requirements of GAAS (or, if applicable, the standards promulgated by the PCAOB) and
- b. the component auditor has issued an auditor's report on ICFR that is not restricted as to use. (Ref: par. .A127–.A128)

### **Additional Information**

.80 When management includes, either within management's report or in a document containing management's report, information in addition to the elements that are subject to the auditor's evaluation as described in paragraph .55, the auditor should

- a. disclaim an opinion, in an other-matter paragraph, on the additional information when such information is included in management's report. (Ref: par. .A129)
- b. read the additional information to identify material inconsistencies with management's report and material misstatements of fact when such information is included outside management's report in a document containing management's report and the related auditor's report. If, upon reading the additional information, the auditor becomes aware of an apparent material inconsistency or misstatement of fact, the auditor should apply the requirements in section 720, *Other Information in Documents Containing Audited Financial Statements*, adapted as necessary, to the audit of ICFR. (Ref: par. .A130)

## **Special Topics**

### **Entities With Multiple Components**

.81 In determining the components at which to perform tests of controls, the group engagement team should assess the risk of material misstatement to the financial statements associated with the component and correlate the amount of attention devoted to the component with the degree of risk. (Ref: par. .A131–.A133)

.82 In assessing and responding to risk, the group engagement team should test, or have a component auditor test on the group engagement team's behalf, controls over specific risks that present a reasonable possibility of material misstatement to the group financial statements. (Ref: par. .A134)

.83 In applying the requirement in paragraph .42 regarding special considerations for subsequent years' audits, the group engagement team should

<sup>7</sup> Paragraph .15 of section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.

<sup>8</sup> Paragraph .24 of section 600.

vary the nature, timing, and extent of tests of controls at components from year to year.

#### *Special Situations*

**.84** For equity method investment components, the scope of the audit should include controls over the reporting in the entity's financial statements of the entity's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures, in accordance with the applicable financial reporting framework. (Ref: par. .A135)

**.85** Except as indicated in paragraph .86, the scope of the audit should include entities that are acquired on or before the date specified in management's assessment about ICFR and operations that are accounted for as discontinued operations on the date specified in management's assessment about ICFR that are reported in accordance with the applicable financial reporting framework in the entity's financial statements.

**.86** In situations in which management elects to limit its assessment by excluding certain entities, the auditor should evaluate whether it is appropriate, in the auditor's judgment, to do so. If the auditor concludes that it is appropriate, the auditor should include in the introductory paragraph of the report a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment about ICFR and the auditor's audit of ICFR. Additionally, the auditor should evaluate the appropriateness of management's disclosure related to such a limitation. (Ref: par. .A136)

**.87** If the auditor believes that management's disclosure about the limitation requires modification, the auditor should communicate the matter to the appropriate level of management. If, in the auditor's judgment, management does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should inform those charged with governance of the matter as soon as practicable. If management and those charged with governance do not respond appropriately, the auditor should modify the auditor's report on the audit of ICFR to include an other-matter paragraph describing the reasons why the auditor believes management's disclosure requires modification.

#### ***Use of Service Organizations***

**.88** When the entity uses the services of a service organization, the auditor should consider the activities of the service organization when determining the evidence required to support the auditor's opinion on the effectiveness of an entity's ICFR. (Ref: par. .A137–.A138)

**.89** The auditor is required to perform the procedures in section 402, *Audit Considerations Relating to an Entity Using a Service Organization*, with respect to the activities performed by the service organization.<sup>9</sup> In an audit of ICFR, the auditor should also obtain evidence that controls at the service organization that are relevant to the auditor's opinion on ICFR are operating effectively. (Ref: par. .A139–.A140)

**.90** If the auditor plans to use a type 2 report as audit evidence that controls are operating effectively, the auditor should determine whether the type 2 report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the auditor's opinion by evaluating

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<sup>9</sup> Paragraphs .09–.19 of section 402, *Audit Considerations Relating to an Entity Using a Service Organization*.

- a. the time period covered by the tests of controls and its relation to the as of date;
- b. the scope of the service auditor's work and the services and processes covered, the controls tested, and the tests that were performed and the way in which tested controls relate to the entity's controls; and
- c. the results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls. (Ref: par. .A141)

**.91** The auditor should determine whether complementary user entity controls identified in the type 2 report are relevant in addressing the risks of material misstatement and, if so, evaluate the entity's design and implementation of the relevant complementary user entity controls and test their operating effectiveness. (Ref: par. .A142)

**.92** In determining whether the type 2 report provides sufficient appropriate audit evidence to support the auditor's opinion on ICFR, the auditor should be satisfied regarding the following:

- a. The service auditor's professional competence and independence from the service organization. (Ref: par. .A143)
- b. The adequacy of the standards under which the type 2 report was issued. (Ref: par. .A144)

**.93** The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report. If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the entity's ICFR. The auditor also should evaluate whether the results of other procedures the auditor performed indicate that there have been changes in the controls at the service organization. (Ref: par. .A145)

**.94** The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors:

- a. The elapsed time between the time period covered by the tests of controls in the service auditor's report and the as of date
- b. The significance of the activities of the service organization
- c. Whether there are errors that have been identified in the service organization's processing
- d. The nature and significance of any changes in the service organization's controls identified by management or the auditor (Ref: par. .A146)

**.95** When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the as of date, additional procedures should be performed to obtain sufficient appropriate audit evidence about the operating effectiveness of the controls at the service organization that are relevant to the auditor's opinion on ICFR.

**.96** The auditor should not refer to the service auditor's report when expressing an opinion on ICFR.



**Benchmarking of Automated Controls**

**.97** To determine whether to use a benchmarking strategy for testing an automated application control, the auditor should assess the following risk factors:

- a. The extent to which the application control can be matched to a defined program within an application
- b. The extent to which the application is stable (that is, there are few changes from period to period)
- c. The availability and reliability of a report of the compilation dates of the programs placed in production (Ref: par. .A147–.A150)

**.98** When using a benchmarking strategy, the auditor should obtain evidence to determine that the automated application control has not changed. (Ref: par. .A151–.A152)

**.99** After a period of time, the length of which depends upon the circumstances, the baseline of the operation of an automated application control should be reestablished. To determine when to reestablish a baseline, the auditor should evaluate the following factors:

- a. The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls, and computer operations
- b. The auditor's understanding of the nature of changes, if any, on the specific programs that contain the controls
- c. The nature and timing of other related tests
- d. The consequences of errors associated with the application control that was benchmarked
- e. Whether the control is sensitive to other business factors that may have changed (Ref: par. .A153)

**Application and Other Explanatory Material****Scope of This Section (Ref: par. .01–.02)**

**.A1** Certain regulatory bodies, such as the FDIC, require the audit of ICFR and the audit of financial statements to be performed by the same auditor.<sup>10</sup> Inherent difficulties exist when integrating the audit of ICFR and the audit of the financial statements to meet the requirements of this section when the audit of the financial statements is performed by a different auditor. Nonetheless, if the audit of the financial statements and the audit of ICFR are performed by different auditors, the audits are required by this section to be integrated.

**Objectives (Ref: par. .04)**

**.A2** See section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, for additional explanation related to the auditor's objective to obtain reasonable assurance.<sup>11</sup>

<sup>10</sup> See Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) (Section 36 of the Federal Deposit Insurance Act [FDI Act], 12.U.S.C. 1831m) and its implementing regulation, 12 CFR Part 363.3(b).

<sup>11</sup> Paragraph .06 of section 200.

**.A3** Effective ICFR provides an entity with reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with the applicable financial reporting framework. If one or more material weakness exists, the entity's ICFR cannot be considered effective. The evaluation of the effectiveness of the entity's ICFR required by this section encompasses all relevant control objectives of the entity's ICFR; therefore, the identification of one material weakness in ICFR does not justify the auditor ceasing to perform procedures to evaluate the effectiveness of all relevant control objectives of the entity's ICFR.

**.A4** The auditor is not required to plan and perform the integrated audit to identify deficiencies that, individually or in combination, are less severe than a material weakness.

## **Definitions (Ref: par. .05)**

### ***Criteria***

**.A5** For purposes of this section, the subject matter is ICFR.

### ***Internal Control Over Financial Reporting***

**.A6** The auditor's procedures performed as part of the integrated audit are not part of an entity's ICFR.

**.A7** For insured depository institutions (IDIs) subject to the internal control reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), ICFR includes controls over the preparation of the IDI's financial statements in accordance with generally accepted accounting principles (GAAP) and with the instructions to the Consolidated Financial Statements for Bank Holding Companies. ICFR also includes controls over the preparation of the IDI's financial statements in accordance with GAAP and controls over the preparation of schedules equivalent to the basic financial statements in accordance with the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income (Call Report Instructions).

### ***Management's Assessment About ICFR***

**.A8** Exhibit C, "Illustrative Management Report," includes an illustration of a management report.

## **Preconditions for the Audit of ICFR (Ref: par. .06–.07)**

**.A9** Management is responsible for identifying and documenting the controls and the control objectives that they were designed to achieve. Such documentation serves as a basis for management's assessment about ICFR. Documentation of the design of controls, including changes to those controls, is evidence that controls upon which management's assessment about ICFR is based are

- identified.
- capable of being communicated to those responsible for their performance.
- capable of being monitored and evaluated by the entity.

**.A10** Management's documentation may take various forms, for example, entity policy manuals, accounting manuals, narrative memoranda, flowcharts,

decision tables, procedural write-ups, or completed questionnaires. No one particular form of documentation is prescribed, and the extent of documentation may vary depending upon the size and complexity of the entity and the entity's monitoring activities.

**.A11** Management's monitoring activities also may provide evidence of the design and operating effectiveness of ICFR in support of management's assessment about ICFR. Monitoring of controls is a process to assess the effectiveness of ICFR performance over time. It involves assessing the effectiveness of controls on a timely basis, identifying and reporting deficiencies to appropriate individuals within the organization, and taking necessary corrective actions. Management accomplishes monitoring of controls through ongoing evaluations, separate evaluations, or a combination of the two.

**.A12** Ongoing evaluations are often built into the normal recurring activities of an entity and include regular management and supervisory activities. The greater the degree and effectiveness of ongoing evaluations, the less need for separate evaluations. Management may perform a combination of ongoing and separate evaluations. The scope and frequency of separate evaluations is a matter of management judgment.

**.A13** Ordinarily, the auditor is engaged to audit the effectiveness of the entity's ICFR as of the end of the entity's fiscal year; however, management may select a different date. If the auditor is engaged to audit the effectiveness of an entity's ICFR at a date different from the end of the entity's fiscal year, the audit is, nevertheless, required by paragraph .06b to be integrated with a financial statement audit as of the date specified in management's assessment.

**.A14** Appropriate criteria are both suitable and available to the intended users of management's report on ICFR. Suitable criteria exhibit all of the following characteristics:

- *Relevance.* Criteria are relevant to ICFR.
- *Objectivity.* Criteria are free from bias.
- *Measurability.* Criteria permit reasonably consistent measurements, qualitative or quantitative, of ICFR.
- *Completeness.* Criteria are complete when the evaluation of the effectiveness of ICFR prepared in accordance with the criteria does not omit relevant factors that could reasonably be expected to affect decisions of the intended users made on the basis of management's report on ICFR.

**.A15** Management may select criteria for ICFR that are available publicly in published frameworks or criteria that are available only to specified parties (for example, terms of a contract or criteria issued by an industry association that are available only to those in the industry). When criteria are available only to specified parties, section 905, *Alert That Restricts the Use of the Auditor's Written Communication*, requires that the auditor's report include an other-matter paragraph that restricts the use of the auditor's report.<sup>12</sup>

**.A16** *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 COSO framework) and the U.S. Government Accountability Office's *Standards for Internal Control in the Federal Government* (the Green Book), provide suitable and available criteria against which management may evaluate and report on the

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<sup>12</sup> Paragraph .06 of section 905, *Alert That Restricts the Use of the Auditor's Written Communication*.

effectiveness of the entity's ICFR. If management selects another framework, see paragraph .A14 for guidance on evaluating the suitability of the framework selected by management.

**.A17** *Internal control*, as defined by the framework used by management, may be more broadly defined than ICFR. However, this section focuses only on ICFR.

### **Integrating the Audit of ICFR With the Financial Statement Audit (Ref: par. .09-.13)**

**.A18** Obtaining sufficient appropriate audit evidence to support the operating effectiveness of controls for purposes of the financial statement audit ordinarily allows the auditor to modify the substantive procedures that otherwise would have been necessary to opine on the financial statements.

**.A19** Section 500, *Audit Evidence*, provides additional explanation with respect to obtaining sufficient appropriate audit evidence.

**.A20** Consideration of the results of tests of controls may cause the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified deficiencies.

### **Planning the Audit of ICFR (Ref: par. .14)**

**.A21** Evaluating whether the following matters are important to the entity's financial statements and ICFR and, if so, how they may affect the auditor's procedures may assist the auditor in planning the audit of ICFR:

- Knowledge of the entity's ICFR obtained during other engagements performed by the auditor or, if applicable, during a review of a predecessor auditor's working papers
- Matters affecting the industry in which the entity operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes
- Matters relating to the entity's business, including its organization, operating characteristics, and capital structure
- The extent of recent changes, if any, in the entity, its operations, or its ICFR
- The auditor's preliminary judgments about financial statement materiality, risk, and other factors relating to the determination of material weaknesses
- Deficiencies previously communicated to those charged with governance or management
- Legal or regulatory matters of which the entity is aware
- The type and extent of available evidence related to the effectiveness of the entity's ICFR
- Preliminary judgments about the effectiveness of ICFR
- Public information about the entity relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the entity's ICFR

- Knowledge about risks related to the entity evaluated as part of the auditor's client acceptance and retention evaluation
- The relative complexity of the entity's operations

***Role of Risk Assessment (Ref: par. .15)***

**.A22** Risk assessment underlies the entire audit process described by this section, including the determination of significant classes of transactions, account balances, and disclosures, and their relevant assertions, the selection of controls to test, and the determination of the evidence necessary to conclude on the effectiveness of a given control. The risk assessment procedures described in section 315 support both the financial statement audit and the audit of ICFR.

***Scaling the Audit***

**.A23** The size and complexity of the entity, its business processes, and structure may affect the way in which the entity achieves many of its control objectives. Many smaller entities have less complex operations. Additionally, some larger, complex entities may have less complex units or processes. Factors that might indicate less complex operations include fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control. Accordingly, a smaller, less complex entity, or even a larger, less complex entity might achieve its control objectives differently from a more complex entity.

**.A24** The size and complexity of the entity, its business processes, and structure also may affect the auditor's risk assessment and the determination of the necessary procedures and the controls necessary to address those risks. Scaling is most effective as a natural extension of the risk-based approach and applicable to audits of all entities.

***Addressing the Risk of Fraud (Ref: par. .16–.17)***

**.A25** Section 240 addresses the auditor's identification and assessment of the risks of material misstatement due to fraud.<sup>13</sup> Controls that might address these risks include

- controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- controls over journal entries and adjustments made in the period-end financial reporting process;
- controls over related party transactions;
- controls related to significant management estimates; and
- controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

***Using the Work of Internal Auditors or Others (Ref: par. .18–.19)***

**.A26** The extent of the procedures necessary to obtain the understanding required by paragraph .18 will vary, depending on the nature of those activities. In performing risk assessment procedures, the auditor is required to inquire of appropriate individuals within the internal audit function (if such function

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<sup>13</sup> Paragraphs .25–.27 of section 240.

exists).<sup>14</sup> Section 315 provides guidance with respect to such inquiries and certain additional procedures based on the responses to such inquiries.<sup>15</sup>

**.A27** In an audit of ICFR, the external auditor may use the work of the internal audit function in obtaining audit evidence or use internal auditors to provide direct assistance under the direction, supervision, and review of the external auditor. For purposes of the audit of ICFR, however, the auditor also may use the work performed by, or receive direct assistance from, others. Others include entity personnel (in addition to internal auditors) and third parties working under the direction of management or those charged with governance that provide evidence about the effectiveness of ICFR. In an integrated audit, the auditor also may use the work of internal auditors or others to obtain evidence supporting the assessment of control risk for purposes of the financial statement audit.

**.A28** As the risk associated with a control increases, the need for the auditor to directly perform work on the control increases (for example, for controls that address specific fraud risks, use of the work of the internal audit function or others would be limited, if it could be used at all).

**.A29** For purposes of evaluating the competence and objectivity of others in accordance with section 610, *competence* means the attainment and maintenance of a level of understanding, knowledge, and skills that enables that person to ably perform the tasks assigned to them, and *objectivity* means the ability to perform those tasks impartially and with intellectual honesty, without allowing bias, conflict of interest, or undue influence of others to override professional judgments.<sup>16</sup> The more objective and the higher level of competence, the more likely the external auditor may use the work of others and make use of it in more areas.

**.A30** Others may have an approach that differs from that of an internal audit function, particularly with respect to the level of formality. However, it would be inappropriate to use the work of others that do not have a systematic and disciplined approach, including quality control, as required by section 610. Section 610 provides additional requirements and guidance in determining when to use the work, in which areas, and to what extent.

#### **Materiality (Ref: par. .20)**

**.A31** Section 320, *Materiality in Planning and Performing an Audit*, provides additional explanation of materiality.

#### **Using a Top-Down Approach (Ref: par. .21)**

**.A32** The *top-down approach* describes the auditor's sequential thought process in identifying risks and the controls to test, not necessarily the order in which the auditor will perform the audit procedures.

**.A33** A top-down approach involves

- beginning at the financial statement level;
- using the auditor's understanding of the overall risks to ICFR;
- focusing on entity-level controls;

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<sup>14</sup> Paragraph .06a of section 315.

<sup>15</sup> Paragraphs .A9–.A13 of section 315.

<sup>16</sup> Paragraphs .13 and .A5–.A9 of section 610, *Using the Work of Internal Auditors*.

- working down to significant classes of transactions, account balances, and disclosures, and their relevant assertions;
- directing attention to classes of transactions, accounts, disclosures, and assertions that present a reasonable possibility of material misstatement of the financial statements;
- verifying the auditor's understanding of the risks in the entity's processes; and
- selecting controls for testing that sufficiently address the assessed risk of material misstatement to each relevant assertion.

**Entity-Level Controls (Ref: par. .22)**

**.A34** The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

**.A35** Entity-level controls include

- controls related to the control environment;
- controls over management override;
- the entity's risk assessment process;
- centralized processing and controls, including shared service environments;
- controls to monitor results of operations;
- controls to monitor other controls, including activities of the internal audit function, those charged with governance, and self-assessment programs;
- controls over the period-end financial reporting process; and
- programs and controls that address significant business risks.

**.A36** Entity-level controls vary in nature and precision:

- Some entity-level controls, such as certain control environment controls, have an important but indirect effect on the likelihood that a misstatement will be prevented, or detected and corrected, on a timely basis. These controls might affect the other controls that the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.
- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that material misstatements to a relevant assertion will be prevented, or detected and corrected, on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls.
- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent, or detect and correct, on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of material misstatement, the auditor need not test additional controls relating to that risk.

*Considerations Specific to Smaller, Less Complex Entities*

**.A37** Controls over management override are important to effective ICFR for all entities and may be particularly important at smaller, less complex entities because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller, less complex entities, the controls that address the risk of management override might be different from those at a larger entity. For example, a smaller, less complex entity might rely on more detailed oversight by those charged with governance that focuses on the risk of management override.

***Evaluating the Components of ICFR (Ref: par. .23)***

**.A38** ICFR is often described as consisting of five components: control environment, risk assessment, control activities, information and communication, and monitoring. The components are necessary to an effective system of ICFR.<sup>17</sup> This description does not necessarily reflect how an entity designs, implements, and maintains ICFR nor how it may classify any particular component. Auditors may use different terminology or frameworks to describe the various aspects of ICFR and their effect on the audit other than those used in this section, provided that all the components described in this section are addressed. Entities select and develop controls within each component. Controls are interrelated and may support multiple objectives.

**.A39** The 2013 COSO framework includes principles related to each component that are suitable to all entities. The 2013 COSO framework presumes that all principles are relevant because they have a significant bearing on the presence and functioning of an associated component. There may be a rare industry, operating, or regulatory situation in which management has determined that a principle is not relevant to a component. Considerations in applying this judgment may include the entity structure recognizing any legal, regulatory, industry, or contractual requirements for governance of the entity, and the level of use and dependence on technology used by the entity. The 2013 COSO framework states that management must support its determination that a principle is not relevant with the rationale of how, in the absence of that principle, the associated component can be present and functioning.<sup>18</sup>

**.A40** When management uses the 2013 COSO framework, the guidance described in paragraphs .A41–.A48 to evaluate the five components is applicable. When management uses the Green Book or another framework, the auditor may adapt the guidance in paragraphs .A41–.A48, as necessary, based on the criteria contained in the framework used by management. For example, when management uses the Green Book, the auditor assesses the relevant principles in the Green Book in lieu of the principles listed in paragraphs .A41–.A48.

*Control Environment*

**.A41** The following principles are relevant to the auditor's evaluation of whether the control environment is present and functioning in the design, implementation, and operation of ICFR to achieve the entity's financial reporting objectives:

- The entity demonstrates a commitment to integrity and ethical values.

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<sup>17</sup> Some material in this section relies upon the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) *Internal Control—Integrated Framework*. The copyright is held by COSO, and the material is used with COSO's permission.

<sup>18</sup> "Suitability and Relevance of Components and Principles" in section 3, "Effective Internal Control" of *Internal Control—Integrated Framework* (COSO, 2013).



- Those charged with governance demonstrate independence from management and exercise oversight of the development and performance of ICFR.
- Management establishes, with oversight of those charged with governance, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of the entity's financial reporting objectives.
- The entity demonstrates a commitment to attract, develop, and retain competent individuals in alignment with the entity's financial reporting objectives.
- The entity holds individuals accountable for their ICFR responsibilities in the pursuit of the entity's financial reporting objectives.

**.A42** The evaluation of whether those charged with governance demonstrate independence from management and exercise oversight of the development and performance of ICFR is performed in the context of the entity's governance structure. As described in section 260, *The Auditor's Communication With Those Charged With Governance*, governance structures may vary by entity, reflecting influences such as size and ownership characteristics.<sup>19</sup> For example, in some smaller entities, those charged with governance and management may be the same people. In such smaller entities, the independence of those charged with governance from management may not be necessary to support the achievement of the entity's financial reporting objectives.

**.A43** The Green Book refers to those charged with governance as the oversight body.

#### *Risk Assessment*

**.A44** The following principles are relevant to the auditor's evaluation of whether the entity's risk assessment is present and functioning in the design, implementation, and operation of ICFR to achieve the entity's financial reporting objectives:

- a. The entity specifies financial reporting objectives with sufficient clarity to enable the identification and assessment of risks related to these objectives.
- b. The entity identifies risks to the achievement of financial reporting objectives across the entity and analyzes risks as a basis for determining how the risks need to be managed.
- c. The entity considers the potential for fraud in assessing risks to the achievement of financial reporting objectives.
- d. The entity identifies and assesses changes that could significantly impact ICFR.

#### *Control Activities Relevant to the Audit of ICFR*

**.A45** The following principles are relevant to the auditor's evaluation of whether the entity's control activities relevant to the audit of ICFR are present and functioning in the design, implementation, and operation of ICFR to achieve the entity's financial reporting objectives:

- a. The entity selects and develops control activities that contribute to the mitigation of risks to the achievement of financial reporting objectives to acceptable levels.

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<sup>19</sup> Paragraph .A6 of section 260, *The Auditor's Communication With Those Charged With Governance*.

- b. The entity selects and develops general control activities over technology to support the achievement of financial reporting objectives.
- c. The entity deploys control activities through policies that establish what is expected and procedures that put policies into action.

**.A46** Control activities relevant to the audit of ICFR include those related to each significant class of transactions, account balance, and disclosure, and its relevant assertions (see paragraphs .26–.28).

*Information and Communication*

**.A47** The following principles are relevant to the auditor's evaluation of whether the entity's information and communication, including the related business processes relevant to financial reporting, is present and functioning in the design, implementation, and operation of ICFR to achieve the entity's financial reporting objectives:

- a. The entity obtains or generates and uses relevant, quality information to support the functioning of ICFR.
- b. The entity internally communicates information, including financial reporting objectives and responsibilities, necessary to support the functioning of ICFR.
- c. The entity communicates with external parties regarding matters affecting the functioning of ICFR.

*Monitoring Activities*

**.A48** The following principles are relevant to the auditor's evaluation of whether the entity's monitoring activities are present and functioning in the design, implementation, and operation of ICFR to achieve the entity's financial reporting objectives:<sup>20</sup>

- a. The entity selects, develops, and performs ongoing or separate evaluations to ascertain whether the components of internal control are present and functioning.
- b. The entity evaluates and communicates deficiencies in ICFR in a timely manner to those parties responsible for taking corrective action, including senior management and those charged with governance, as appropriate.

***Period-End Financial Reporting Process (Ref: par. .24–.25)***

**.A49** Because the annual period-end financial reporting process normally occurs after the as of date, those controls usually cannot be tested until after the as of date.

***Identifying Significant Classes of Transactions, Account Balances, and Disclosures, and Their Relative Assertions (Ref: par. .26–.28)***

**.A50** Risk factors relevant to the identification of significant classes of transactions, account balances, and disclosures, and their relevant assertions include

- size and composition of the account;
- susceptibility to misstatement due to errors or fraud;

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<sup>20</sup> Paragraphs .A102–.A107 and appendix B, "Internal Control Components," of section 315.

- volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- nature of the account, class of transactions, or disclosure;
- accounting and reporting complexities associated with the account, class of transactions, or disclosure;
- exposure to losses in the account;
- possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- existence of related party transactions in the account; and
- changes from the prior period in the account, class of transactions, or disclosure characteristics.

**.A51** The risk factors in paragraph .26 that the auditor is required to evaluate in the identification of significant classes of transactions, account balances, and disclosures, and their relevant assertions, are the same in the audit of ICFR as in the audit of the financial statements; accordingly, significant classes of transactions, account balances, and disclosures, and their relevant assertions, are the same in an integrated audit.

**.A52** The risk assessment procedures performed in connection with a financial statement audit are described in section 315.

**.A53** The auditor might determine the likely sources of potential misstatements by asking himself or herself "What could go wrong?" within a given significant class of transactions, account balance, or disclosure.

**.A54** The components of a potential significant class of transactions, account balance, or disclosure might be subject to significantly different risks. If so, different controls might be necessary to adequately address those risks.

**.A55** Multiple components are discussed further beginning in paragraphs .78 and .81.

#### ***Understanding Likely Sources of Misstatement (Ref: par. .29–.31)***

**.A56** Performing walk-throughs will frequently be the most effective way of achieving the objectives in paragraph .29. A *walk-through* involves following a transaction from origination through the entity's processes, including information systems, until it is reflected in the entity's financial statements, using the same documents and IT that entity personnel use. Walk-through procedures are inquiry of appropriate personnel, observation of the application of specific controls, inspection of relevant documentation, and control reperformance. The auditor may choose any combination of these procedures; however, inquiry alone is not sufficient for achieving the objectives in paragraph .29.

**.A57** A walk-through includes questioning the entity's personnel about their understanding of what is required by the entity's prescribed procedures and controls at the points at which important processing procedures occur. These probing questions, combined with the other walk-through procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walk-through may provide an understanding of the different types of significant transactions handled by the process.

**.A58** The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify likely sources of misstatement and the controls to test, as well as to assess risk and allocate audit effort.

***Selecting Controls to Test (Ref: par. .32)***

**.A59** There might be more than one control that addresses the assessed risk of material misstatement to a particular relevant assertion; conversely, one control might address the assessed risk of material misstatement to more than one relevant assertion. It may not be necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is, itself, a control objective.

**.A60** The decision concerning whether a control would be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of material misstatement to a given relevant assertion rather than on how the control is labeled (for example, entity-level control, transaction-level control, control activity, monitoring control, preventive control, or detective control).

## **Testing Controls**

***Evaluating Design Effectiveness (Ref: par. .33)***

**.A61** Procedures performed to evaluate design effectiveness may include a mix of inquiry of appropriate personnel, observation of the application of specific controls, and inspection of relevant documentation. Walk-throughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

***Considerations Specific to Smaller, Less Complex Entities***

**.A62** A smaller, less complex entity might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex entity might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the entity to implement different controls to achieve its control objectives.

***Testing Operating Effectiveness (Ref: par. .34)***

**.A63** Procedures performed to test operating effectiveness may include a mix of inquiry of appropriate personnel, observation of the application of specific controls, inspection of relevant documentation, and reperformance of the control. Inquiry alone, however, is not sufficient for such purposes. Section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, provides additional guidance on other audit procedures, in combination with inquiry, which may be appropriate when testing the operating effectiveness of controls.<sup>21</sup>

**.A64** In some situations, particularly in smaller, less complex entities, an entity might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for an entity's financial reporting and associated controls, the auditor may take into account the combined competence of entity personnel and other parties that assist with functions related to financial reporting.

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<sup>21</sup> Paragraphs .A28–.A30 of section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

***Relationship of Risk to the Evidence to Be Obtained (Ref: par. .35-.38)***

**.A65** For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness exists.

**.A66** Factors that affect the risk associated with a control may include

- the nature and materiality of misstatements that the control is intended to prevent, or detect and correct;
- the inherent risk associated with the related account(s) and assertion(s);
- whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- whether the account has a history of errors;
- the effectiveness of entity-level controls, especially controls that monitor other controls;
- the nature of the control and the frequency with which it operates;
- the degree to which the control relies on the effectiveness of other controls (for example, the control environment or IT general controls);
- the competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- whether the control relies on performance by an individual or is automated (that is, an automated control would generally be expected to be lower risk if relevant IT general controls are effective); and
- the complexity of the control and the significance of the judgments that would be made in connection with its operation.

**.A67** Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

***Considerations Specific to Smaller, Less Complex Entities***

**.A68** A smaller, less complex entity or component with simple business processes and centralized accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas where off-the-shelf software is used, the auditor's testing of IT controls might focus on the application controls built into the prepackaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls.

**.A69** The auditor's objective is to express an opinion on the entity's ICFR overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

**.A70** The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the

nature, timing, and extent of testing may provide sufficient appropriate audit evidence in relation to the risk associated with the control.

**.A71** Walk-throughs might provide sufficient appropriate audit evidence of operating effectiveness, depending on

- the risk associated with the control being tested,
- the frequency of operation of the control,
- whether the control is an IT application control,
- the specific procedures performed as part of the walk-through, and
- the results of those procedures.

**.A72** The operating effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, informs the auditor's risk assessments in determining the testing necessary to conclude on the operating effectiveness of a control.

#### *Nature of Tests of Controls*

**.A73** Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and reperformance of a control. Inquiry alone, however, does not provide sufficient appropriate audit evidence to support a conclusion about the effectiveness of a control.

**.A74** The nature of the tests of effectiveness that will provide sufficient appropriate audit evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

#### *Considerations Specific to Smaller, Less Complex Entities*

**.A75** A smaller, less complex entity or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of the application of specific controls, inspection of less formal documentation, or reperformance of certain controls, might provide sufficient appropriate audit evidence about whether the control is effective.

**.A76** A *control deviation* occurs when a control does not operate as designed. Control deviations are evaluated when determining whether a deficiency in internal control exists. Because effective ICFR cannot and does not provide absolute assurance of achieving the entity's control objectives, an individual control does not necessarily have to operate without any deviation to achieve the entity's control objectives and to be considered effective.

#### *Timing and Extent of Tests of Controls (Ref: par. .39)*

**.A77** The objective of the tests of controls in an audit of ICFR is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the entity's ICFR. The auditor's opinion relates to the effectiveness of the entity's ICFR as of a point in time and as a whole. Accordingly, an audit of ICFR may entail testing the design and operating effectiveness of controls not tested when expressing an opinion only on the financial statements; however, in both an audit of ICFR and a financial statement audit, the auditor directs attention

to controls that present a reasonable possibility that, if missing or deficient, would result in a material misstatement of the financial statements.

**.A78** Testing controls over a longer period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the as of date provides more evidence than testing performed earlier in the year.

**.A79** The more extensively a control is tested, the greater the evidence obtained from that test.

**.A80** Prior to the as of date, management might implement changes to the entity's controls to make them more effective or efficient or to address deficiencies. If the auditor determines that the new controls achieve the related objectives of the criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, the auditor will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on ICFR. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment in the financial statement audit, the auditor tests the design and operating effectiveness of those superseded controls, as appropriate.

*Rollforward Procedures (Ref: par. .40)*

**.A81** The additional evidence that is necessary to update the results of testing from an interim date to the entity's period-end depends on the following factors:

- The specific control tested prior to the as of date, including the risks associated with the control, the nature of the control, and the results of those tests
- The sufficiency of the evidence of operating effectiveness obtained at an interim date
- The length of the remaining period
- The possibility that there have been any significant changes in ICFR subsequent to the interim date

**.A82** In some circumstances, such as when evaluation of these factors indicates a low risk that the controls are no longer effective during the rollforward period, inquiry alone might be sufficient as a rollforward procedure.

***Special Considerations for Subsequent Years' Audits (Ref: par. .41–.42)***

**.A83** Factors that affect the risk associated with a control in subsequent years' audits include those in paragraph .A66 and the following:

- The nature, timing, and extent of procedures performed in previous audits
- The results of the previous years' testing of the control
- Whether there have been changes in the control or the process in which it operates since the previous audit

**.A84** After taking into account the risk factors identified in paragraphs .A66 and .A83, the additional information available in subsequent years' audits might permit the auditor to assess the risk as lower than in the initial year. This, in turn, might permit the auditor to reduce testing in subsequent years.

**.A85** The auditor also may use a benchmarking strategy for automated application controls in subsequent years' audits. Benchmarking is described further beginning in paragraph .97.

**.A86** The auditor might test controls at a different interim period, increase or reduce the number and types of tests performed, or change the combination of procedures used.

## Identifying Deficiencies in ICFR (Ref: par. .43)

**.A87** The findings from audit work performed on the financial statements and on ICFR are relevant in determining whether the auditor has identified any deficiencies in ICFR.

### ***Determination of Whether Material Weaknesses Exist as of the Date Specified in Management's Assessment About ICFR (Ref: par. .44-.46)***

**.A88** The severity of a deficiency, or a combination of deficiencies, in ICFR depends on

- the magnitude of the potential misstatement resulting from the deficiency or deficiencies and
- whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct, a misstatement of a class of transaction, an account balance, or a disclosure.

A material weakness may exist even though the auditor has not identified misstatements during the integrated audit. Paragraph .A96 provides indicators of material weaknesses.

**.A89** Factors that affect the magnitude of a misstatement that might result from a deficiency, or deficiencies, in ICFR include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency
- The volume of activity (in the current period or expected in future periods) in the account or class of transactions exposed to the deficiency

**.A90** In evaluating the magnitude of the potential misstatement, the maximum amount by which an account balance or total of transactions can be overstated is generally the recorded amount, whereas understatements could be larger.

**.A91** Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, in ICFR will result in a misstatement of an account balance or a disclosure. The factors include the following:

- The nature of the financial statement, classes of transactions, account balances, disclosures, and assertions involved
- The cause and frequency of the exceptions detected as a result of the deficiency, or deficiencies, in ICFR
- The susceptibility of the related asset or liability to loss or fraud
- The subjectivity, complexity, or extent of judgment required to determine the amount involved
- The interaction or relationship of the control(s) with other controls
- The interaction with other deficiencies in ICFR



- The possible future consequences of the deficiency, or deficiencies, in ICFR
- The importance of controls, such as the following, to the financial reporting process:
  - General monitoring controls (such as oversight of management)
  - Controls over the prevention and detection of fraud
  - Controls over the selection and application of significant accounting policies
  - Controls over significant transactions with related parties
  - Controls over significant transactions outside the entity's normal course of business
  - Controls over the period-end financial reporting process (such as controls over nonrecurring journal entries)

**.A92** The evaluation of whether a deficiency in ICFR presents a reasonable possibility of misstatement may be made without quantifying the probability of occurrence as a specific percentage or range. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

**.A93** Controls may be designed to operate individually, or in combination, to effectively prevent, or detect and correct, misstatements. For example, controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the account balance.

**.A94** A deficiency in ICFR on its own may not be sufficiently important to constitute a material weakness. However, a combination of deficiencies affecting the same significant class of transactions, account balance, or disclosure; relevant assertion; or component of ICFR may increase the risks of misstatement to such an extent to give rise to a material weakness. A combination of deficiencies that affect the same significant class of transactions, account balance, or disclosure; relevant assertion; or component of ICFR also may collectively result in a significant deficiency.

**.A95** A compensating control can limit the severity of a deficiency in ICFR and prevent it from being a material weakness. Only compensating controls that operate at a level of precision that would prevent, or detect and correct, a material misstatement are capable of having a mitigating effect. Although compensating controls can mitigate the effects of a deficiency in ICFR, they do not eliminate the deficiency.

**.A96** Indicators of material weaknesses in ICFR include

- identification of fraud, whether or not material, on the part of senior management. For the purpose of this indicator, the term *senior management* includes the principal executive and financial officers as well as any other members of senior management who play a significant role in the entity's financial reporting process;
- restatement of previously issued financial statements to reflect the correction of a material misstatement due to fraud or error;
- identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected and corrected by the entity's ICFR; and

- ineffective oversight of the entity's financial reporting and ICFR by those charged with governance.

***Determination of Whether Significant Deficiencies Exist During the Integrated Audit (Ref: par. .47)***

**.A97** Paragraphs .A88–.A95 provide guidance related to evaluating the severity of identified deficiencies in ICFR. Paragraph .A96 provides indicators of material weaknesses.

**.A98** The evaluation of the severity of each deficiency in ICFR to determine whether the deficiency, individually or in combination, is a significant deficiency is made for purposes of communicating in writing to management and those charged with governance significant deficiencies identified during the integrated audit. See paragraphs .59–.63 for the communication requirements.

***Subsequent Events (Ref: par. .48–.51)***

**.A99** Section 560, *Subsequent Events and Subsequently Discovered Facts*, establishes requirements and provides guidance on subsequent events for a financial statement audit that are adapted and applied, as necessary, to the audit of ICFR. The auditor is required by paragraph .57 to obtain certain written representations from management relating to subsequent events.

**.A100** Refer to paragraph .80 when disclaiming an opinion on management's disclosures about corrective actions.

**.A101** The evaluation of such subsequently discovered facts is similar to the evaluation of subsequently discovered facts in an audit of financial statements, as described in section 560.

***Concluding Procedures (Ref: par. .52–.56)***

**.A102** If management does not revise its report, paragraph .72 applies. Paragraph .70 also applies if the auditor determines that management's required disclosure about one or more material weaknesses is not fairly presented in all material respects. If management refuses to furnish a report that includes management's assessment about ICFR, paragraph .74 applies.

***Obtaining Written Representations (Ref: par. .57–.58)***

**.A103** See section 580, *Written Representations*, for additional requirements and guidance with respect to obtaining written representations from management as part of an audit of financial statements. Section 580 addresses matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updated letter.

**.A104** Management's refusal to furnish written representations constitutes a limitation on the scope of the audit.

***Communicating ICFR-Related Matters (Ref: par. .59–.63)***

**.A105** Section 265, *Communicating Internal Control Related Matters Identified in an Audit*, does not apply to integrated audits.

**.A106** Early communication to management or those charged with governance may be important for some matters because of their relative significance and the urgency of corrective follow-up action. Regardless of the timing of the written communication of significant deficiencies and material weaknesses, the auditor may communicate these orally in the first instance to management and, when appropriate, those charged with governance to assist them in taking

timely remedial action to minimize the risks of material misstatement. However, oral communication does not relieve the auditor of the responsibility to communicate the significant deficiencies and material weaknesses in writing.

**.A107** If a previously communicated significant deficiency or material weakness remains, the current year's communication may repeat the description from the previous communication or simply reference the previous communication and the date of that communication.

**.A108** See section 230, *Audit Documentation*, for additional guidance related to the report release date.<sup>22</sup>

**.A109** The auditor's written communication for a governmental entity would generally not be made prior to management's report on ICFR, the entity's financial statements, and the auditor's report thereon, being made publicly available. This is in order to provide the user with the appropriate context to evaluate the significant deficiencies or material weaknesses identified during the integrated audit that are contained in the written communication.

**.A110** The auditor is not required to perform procedures that are sufficient to identify all deficiencies; rather, the auditor need only communicate deficiencies of which the auditor is aware.

**.A111** Unlike in an audit of financial statements that is not integrated with an audit of ICFR, the auditor is required to communicate in writing deficiencies that do not rise to the level of significant deficiencies or material weaknesses. This is because identifying deficiencies in ICFR is the focus of an audit of ICFR, whereas identifying deficiencies is incidental to an audit of financial statements (that is not integrated with an audit of ICFR), which is focused on identifying misstatements of the financial statements.

**.A112** Because the auditor's written communication of deficiencies identified during the integrated audit forms part of the final audit file, the written communication is subject to the overriding requirement for the auditor to complete the assembly of the final audit file on a timely basis, no later than 60 days following the report release date.<sup>23</sup>

## Reporting on ICFR (Ref: par. .64–.65)

### *Considerations Specific to Governmental Entities*

**.A113** When the audit is also conducted in accordance with *Government Auditing Standards* (also known as the Yellow Book), the auditor may state that the audit was conducted in accordance with the auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. If significant deficiencies in ICFR are identified in such an audit and the auditor's report refers to *Government Auditing Standards*, those standards require the auditor to add the following other-matter paragraphs to the report:

In accordance with *Government Auditing Standards*, we are required to report findings of significant deficiencies. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies in ABC Company's internal control

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<sup>22</sup> Paragraph .A2 of section 230, *Audit Documentation*.

<sup>23</sup> Paragraph .16 of section 230.

described below [*or in the accompanying schedule of findings*] to be significant deficiencies.

ABC Company's response to the findings identified in our examination is described below [*or in the accompanying schedule of findings*]. We did not examine ABC Company's response and, accordingly, we express no opinion on the response.

**.A114** When an other-matter paragraph relating to ICFR is included in a financial statement audit report, the auditor may include a heading above the other-matter paragraph such as "Report on Internal Control Over Financial Reporting." When an other-matter paragraph relating to the financial statement audit is included in an ICFR report, the auditor may include a heading above the other-matter paragraph such as "Report on the Financial Statements."

**.A115** The auditor may choose to issue a combined report (that is, one report containing both an opinion on the financial statements and an opinion on ICFR) or separate reports on the entity's financial statements and on ICFR.

**.A116** If the auditor issues a separate report on ICFR and expresses an adverse opinion on ICFR, the disclosure required by paragraph .71 related to the effect of the adverse opinion on ICFR on the auditor's opinion on the financial statements may be combined with the report language described in paragraph .65.

### Report Modifications (Ref: par. .67)

**.A117** A *limitation on the scope of the audit* refers to the auditor's inability to obtain sufficient appropriate audit evidence, which may arise from the following:

- Circumstances beyond the entity's control
- Circumstances relating to the nature or timing of the auditor's work
- Limitations imposed by management

### Adverse Opinions (Ref: par. .68-.71)

**.A118** Paragraphs .44-.47 describe the evaluation of deficiencies. See paragraphs .73-.77 when the scope of the engagement has been limited.

**.A119** Section 705, *Modifications to the Opinion in the Independent Auditor's Report*, establishes requirements and provides guidance on adverse opinions for a financial statement audit that are adapted and applied, as necessary, to the audit of ICFR. Exhibit A, "Illustrative Reports," of this section includes an illustration of the application of the reporting requirements in section 705.<sup>24</sup>

**.A120** The auditor's report need only refer to the "material weaknesses described in management's report" and need not include a description of each material weakness, provided each material weakness is included and fairly presented in all material respects in management's report, as described in paragraph .70.

**.A121** As described in paragraph .A116, if the auditor issues a separate report on ICFR in this circumstance, the disclosure required by paragraph .71 may be combined with the report language described in paragraph .65.

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<sup>24</sup> Illustration 2, "Adverse Opinion on ICFR," of exhibit A, "Illustrative Reports."

***Scope Limitations (Ref: par. .73–.77)***

**.A122** The auditor may be separately engaged to audit only the financial statements after withdrawing from the integrated audit. In such circumstances, the auditor cannot disregard knowledge obtained in the integrated audit engagement in determining whether to accept, or in performing, the financial statement audit.

**.A123** Section 705 establishes requirements and provides guidance on disclaimers of opinion for a financial statement audit that are adapted and applied, as necessary, to the audit of ICFR. Exhibit A of this section includes an illustration of the application of the reporting requirements in section 705.<sup>25</sup>

**.A124** In an audit of ICFR, the auditor is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that the auditor will not be able to obtain sufficient appropriate audit evidence to express an opinion.

**.A125** The auditor's report need only refer to the "material weaknesses described in management's report" and need not include a description of each material weakness, provided each material weakness is included and fairly presented in all material respects in management's report.

***Making Reference to a Component Auditor and Assuming Responsibility for the Work of a Component Auditor (Ref: par. .78–.79)***

**.A126** Section 600 addresses special considerations that apply to group audits, in particular those that involve component auditors. Section 600 is applicable, adapted as necessary, to the audit of ICFR, considering the requirements and guidance related to multiple components discussed beginning in paragraphs .28 and .81.

**.A127** The group engagement partner may decide to assume responsibility for the work of the component auditor or to make reference to the component auditor in the report on the ICFR over the group financial statements. The decision about whether to make reference to a component auditor in the report on the audit of ICFR might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the group financial statements may make reference to the audit of a significant equity investment performed by a component auditor, but the report on the ICFR over the group financial statements might not make a similar reference because management's assessment about ICFR ordinarily would not extend to controls at the equity method investee. See paragraph .84 for further discussion of the evaluation of the controls for an equity method investment.

**.A128** Section 600 establishes requirements and provides guidance when assuming responsibility for the work of a component auditor and when making reference to a component auditor in the auditor's report on the financial statements that are adapted and applied, as necessary, to the audit of ICFR. Exhibit A of this section includes an illustration of the application of the reporting requirements in section 600.<sup>26</sup>

***Additional Information (Ref: par. .80)***

**.A129** The following is an example of wording used to disclaim an opinion on such additional information:

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<sup>25</sup> Illustration 3, "Disclaimer of Opinion on ICFR," of exhibit A.

<sup>26</sup> Illustration 4, "Unmodified Opinion on ICFR Making Reference to a Component Auditor," of exhibit A.

**Other Matter**

We did not perform auditing procedures on *[describe additional information, such as management's cost-benefit statement]*, and accordingly, we do not express an opinion or provide any assurance on it.

**.A130** An entity may publish various documents that contain information in addition to management's report and the auditor's report on ICFR. Section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, as well as section 720, may require the auditor to take additional action.

**Special Topics*****Entities With Multiple Components (Ref: par. .81–.83)***

**.A131** As indicated in paragraph .A126 of this section, section 600 is applicable, adapted as necessary, to the audit of ICFR, considering the requirements and guidance related to components discussed in this section.

**.A132** In determining the components at which to perform tests of controls, the group engagement team may also take into account work performed by the internal audit function or others on behalf of management. For example, if the internal audit function's planned procedures include relevant audit work at various components, the auditor may coordinate work with the internal auditors and reduce the number of components at which the group engagement team, or a component auditor on the group engagement team's behalf, would otherwise need to perform audit procedures.

**.A133** The group engagement team may eliminate from further consideration components that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the group financial statements.

**.A134** In lower risk components, the group engagement team first might evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides sufficient appropriate audit evidence. The group engagement team or a component auditor on the group engagement team's behalf may test the operating effectiveness of controls over specific risks or group-wide controls.

***Special Situations (Ref: par. .84–.87)***

**.A135** The audit of ICFR ordinarily would not extend to controls at the equity method investee.

**.A136** The auditor may conclude it is appropriate for management to limit the assessment by excluding certain entities when, for example, management has insufficient time to assess the controls at the as of date for a recently acquired business or does not have sufficient access to a consolidated variable interest entity. However, in the case of an acquired entity, it would not be appropriate for management to limit its assessment if the period of such limitation extends beyond one year from the date of acquisition, nor would it be appropriate for management's assessment to be limited for more than one annual management report on ICFR. Law or regulation may specifically address situations in which it is appropriate for management to limit its assessment by excluding certain entities and also may require specific disclosures in these cases. If, in the auditor's judgment, it is appropriate for management to limit its assessment by excluding certain entities, the auditor may limit the audit of ICFR in the same manner, and the auditor's opinion would not be affected by a scope limitation.

**Use of Service Organizations (Ref: par. .88–.96)**

**.A137** Section 402 contains the requirements and application guidance for auditors of the financial statements of entities that use a service organization (user auditors). Section 402 addresses an auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of an entity that uses one or more service organizations (a user entity). Refer to section 402 for guidance when the service organization uses a subservice organization.<sup>27</sup>

**.A138** Section 402 identifies the situations in which a service organization's services and controls over them are part of a user entity's information system.<sup>28</sup> If the service organization's services are part of the user entity's information system, as described therein, then they are part of the user entity's ICFR.

**.A139** Evidence that the controls that are relevant to the auditor's opinion on ICFR are operating effectively may be obtained by following the procedures described in section 402.<sup>29</sup> These procedures include one or more of the following:

- a. Obtaining and reading a service auditor's report on management's description of a service organization's system and the suitability of the design and operating effectiveness of controls, which includes a description of the service auditor's tests of controls and results (a type 2 report), if available
- b. Performing appropriate tests of controls at the service organization
- c. Using another auditor to perform tests of controls at the service organization on behalf of the auditor

**.A140** A report on management's description of a service organization's system and the suitability of the design of controls (a type 1 report) does not include a description of the service auditor's tests of controls and results of those tests or the service auditor's opinion on the operating effectiveness of controls and, therefore, does not provide evidence of the operating effectiveness of controls. Type 1 and type 2 reports are described in section 402.

**.A141** These factors are similar to factors the auditor would consider in determining whether the report provides sufficient appropriate audit evidence to support the auditor's assessed level of control risk in an audit of the financial statements, as described in section 402.<sup>30</sup>

**.A142** Section 402 defines *complementary user entity controls* as those controls that management of the service organization assumes, in the design of its service, will be implemented by user entities, and, if necessary to achieve the control objectives stated in management's description of the service organization's system, are identified as such in that description.

**.A143** Appropriate sources of information concerning the service auditor's professional competence and independence are discussed in section 402.<sup>31</sup>

**.A144** Standards promulgated by a body designated by Council, pursuant to the "Compliance With Standards Rule" of the AICPA Code of Professional

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<sup>27</sup> Paragraph .A20 of section 402.

<sup>28</sup> Paragraph .03 of section 402.

<sup>29</sup> Paragraphs .16–.17 of section 402.

<sup>30</sup> Paragraphs .A32–.A39 of section 402.

<sup>31</sup> Paragraphs .A21–.A22 of section 402.

Conduct, are presumed to be adequate. Although the International Auditing and Assurance Standards Board (IAASB) is not such a body, AT-C section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting*, may be helpful when the service auditor's report is issued in accordance with International Standard on Assurance Engagements 3402, *Assurance Reports on Controls at a Service Organization*, promulgated by the IAASB.<sup>[32]</sup> [Revised, April 2017, to reflect conforming changes necessary due to the issuance of SSAE No. 18.]

**.A145** Changes in the service organization's controls may include

- changes communicated to management from the service organization, including those related to the service organization's processes and information systems.
- changes in personnel at the service organization with whom management interacts.
- changes in the design or implementation of controls that were necessary to achieve the control objectives.
- changes in reports or other data received from the service organization.
- changes in contracts or service level agreements with the service organization.
- errors identified in the service organization's processing or incidents of noncompliance with laws and regulations or fraud.

**.A146** As risk increases, the need for the auditor to obtain additional evidence increases. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures might include

- evaluating procedures performed by management and the results of those procedures.
- contacting the service organization, through the user entity, to obtain specific information.
- requesting that a service auditor be engaged to perform procedures that will supply the necessary information.
- visiting the service organization and performing such procedures.

***Benchmarking of Automated Controls (Ref: par. .97-.99)***

**.A147** Entirely automated application controls are generally less susceptible to breakdowns due to human failure. This feature may allow the auditor to use a benchmarking strategy. *Benchmarking* is the process of testing an automated application control to establish a baseline that can be combined with effective IT general controls to allow the auditor to conclude that the automated application controls are effective without repeating the specific tests of operating effectiveness.

**.A148** When the risk factors assessed in determining a benchmarking strategy indicate lower risk, the control being evaluated might be well-suited for benchmarking. When these factors indicate increased risk, the control being evaluated is less suited for benchmarking.

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<sup>[32]</sup> [Footnote deleted, April 2017, to reflect conforming changes necessary due to the issuance of SSAE No. 18.]



**.A149** A report of the compilation dates of the programs placed in operation may be used as evidence that controls within the program have not changed.

**.A150** Benchmarking automated application controls can be especially effective for entities using purchased software when the possibility of program changes is remote (for example, when the vendor does not allow access or modification to the source code).

**.A151** If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor determines that the automated application control has not changed since the auditor established a baseline (that is, last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor obtains to determine that the control has not changed may vary depending on the circumstances, including the strength of the entity's program change controls.

**.A152** The consistent and effective functioning of the automated application controls may be dependent upon the related files, tables, data, and parameters. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

**.A153** A control may be sensitive to other business factors that may have changed. For example, an automated control may have been designed with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.

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## Exhibit A—Illustrative Reports

The following illustrate the report elements described in this section. The illustrations assume that the audit of internal control over financial reporting (ICFR) and the audit of the financial statements were performed by the same auditor. Report modifications are discussed beginning in paragraph .67 of this section.

Illustration 1—Unmodified Opinion on ICFR

Illustration 2—Adverse Opinion on ICFR

Illustration 3—Disclaimer of Opinion on ICFR

Illustration 4—Unmodified Opinion on ICFR Making Reference to a Component Auditor

Illustration 5—Combined Report Expressing an Unmodified Opinion on ICFR and an Unmodified Opinion on the Financial Statements

### Illustration 1—Unmodified Opinion on ICFR

The following is an illustrative report expressing an unmodified opinion on ICFR.

#### Independent Auditor's Report

[Appropriate Addressee]

#### **Report on Internal Control Over Financial Reporting<sup>1</sup>**

We have audited ABC Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].<sup>2</sup>

#### ***Management's Responsibility for Internal Control Over Financial Reporting***

Management is responsible for designing, implementing, and maintaining effective internal control over financial reporting, and for its assessment about the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report].

#### ***Auditor's Responsibility***

Our responsibility is to express an opinion on the entity's internal control over financial reporting 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 effective internal control over financial reporting was maintained in all material respects.

<sup>1</sup> The subtitle "Report on Internal Control Over Financial Reporting" is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

<sup>2</sup> For example, the following may be used to identify the criteria: "criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

An audit of internal control over financial reporting involves performing procedures to obtain audit evidence about whether a material weakness exists. The procedures selected depend on the auditor's judgment, including the assessment of the risks that a material weakness exists. An audit includes obtaining an understanding of internal control over financial reporting and testing and evaluating the design and operating effectiveness of internal control over financial reporting based on the assessed risk.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

***Definition and Inherent Limitations of Internal Control Over Financial Reporting***

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with *[applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]*. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with *[applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]*, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements. Also, projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

***Opinion***

In our opinion, ABC Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*.

***Report on Financial Statements***

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the *[identify financial statements]* of ABC Company, and our report dated *[date of report, which should be the same as the date of the report on the audit of ICFR]* expressed *[include nature of opinion]*.

***Report on Other Legal and Regulatory Requirements***

*[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]*

*[Auditor's signature]*

*[Auditor's city and state]*

*[Date of the auditor's report]*

**Illustration 2—Adverse Opinion on ICFR**

The following is an illustrative report expressing an adverse opinion on ICFR. In this example, the opinion on the financial statements is not affected by the adverse opinion on ICFR.

**Independent Auditor's Report**

[Appropriate Addressee]

**Report on Internal Control Over Financial Reporting<sup>1</sup>**

We have audited ABC Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].<sup>2</sup>

***Management's Responsibility for Internal Control Over Financial Reporting***

Management is responsible for designing, implementing, and maintaining effective internal control over financial reporting, and for its assessment about the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report].

***Auditor's Responsibility***

Our responsibility is to express an opinion on the entity's internal control over financial reporting 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 effective internal control over financial reporting was maintained in all material respects.

An audit of internal control over financial reporting involves performing procedures to obtain evidence about whether a material weakness exists. The procedures selected depend on the auditor's judgment, including the assessment of the risks that a material weakness exists. An audit includes obtaining an understanding of internal control over financial reporting and testing and evaluating the design and operating effectiveness of internal control over financial reporting based on the assessed risk.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse audit opinion.

***Definition and Inherent Limitations of Internal Control Over Financial Reporting***

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as

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<sup>1</sup> The subtitle "Report on Internal Control Over Financial Reporting" is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

<sup>2</sup> For example, the following may be used to identify the criteria: "criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction, of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements. Also, projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

#### ***Basis for Adverse Opinion***

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. The following material weakness has been identified and included in the accompanying [*title of management's report*].

[*Identify the material weakness described in management's report.*]<sup>3</sup>

#### ***Adverse Opinion***

In our opinion, because of the effect of the material weakness described in the Basis for Adverse Opinion paragraph on the achievement of the objectives of [*identify criteria*], ABC Company has not maintained effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].

#### ***Report on Financial Statements***

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [*identify financial statements*] of ABC Company, and our report dated [*date of report, which should be the same as the date of the report on the audit of ICFR*] expressed [*include nature of opinion*]. We considered the material weakness identified above in determining the nature, timing, and extent of audit procedures applied in our audit of the 20XX financial statements, and this report does not affect such report on the financial statements.

#### ***Report on Other Legal and Regulatory Requirements***

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

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<sup>3</sup> See paragraphs .68–.71 of this section for specific reporting requirements. The auditor's report need only refer to the material weaknesses described in management's report and need not include a description of each material weakness, provided each material weakness is included and fairly presented in all material respects in management's report.

**Illustration 3—Disclaimer of Opinion on ICFR**

The following is an illustrative report expressing a disclaimer of opinion on ICFR. In this example, the auditor is applying paragraph .76 of this section because a material weakness was identified during the limited procedures performed by the auditor.

**Independent Auditor's Report**

*[Appropriate Addressee]*

**Report on Internal Control Over Financial Reporting<sup>1</sup>**

We were engaged to audit ABC Company's internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*.<sup>2</sup>

***Management's Responsibility for Internal Control Over Financial Reporting***

Management is responsible for designing, implementing, and maintaining effective internal control over financial reporting and for its assessment about the effectiveness of internal control over financial reporting included in the accompanying *[title of management's report]*.

***Auditor's Responsibility***

Our responsibility is to express an opinion on ABC Company's internal control over financial reporting based on conducting the audit in accordance with auditing standards generally accepted in the United States of America. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

***Definition and Inherent Limitations of Internal Control Over Financial Reporting***

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with *[applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]*. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with *[applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]*, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

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<sup>1</sup> The subtitle "Report on Internal Control Over Financial Reporting" is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

<sup>2</sup> For example, the following may be used to identify the criteria: "criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements. Also, projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

***Basis for Disclaimer of Opinion***

*[Provide a description of the matter giving rise to the disclaimer of opinion.]*

***Material Weakness***

Because of the matter described above, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. However, a material weakness has been identified. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. If one or more material weaknesses exist, an entity's internal control over financial reporting cannot be considered effective. The following material weakness has been included in the accompanying *[title of management's report]*.

*[Identify the material weakness described in management's report and include a description of the material weakness, including its nature and its actual and potential effect on the presentation of the entity's financial statements issued during the existence of the material weakness.]*

***Disclaimer of Opinion***

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the effectiveness of ABC Company's internal control over financial reporting.

***Report on Financial Statements***

We have audited, in accordance with auditing standards generally accepted in the United States of America, the *[identify financial statements]* of ABC Company, and our report dated *[date of report, which should be the same as the date of the report on the audit of ICFR]* expressed *[include nature of opinion]*. We considered the material weakness identified above in determining the nature, timing, and extent of audit procedures applied in our audit of the 20XX financial statements, and this report does not affect such report on the financial statements.

***Report on Other Legal and Regulatory Requirements***

*[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]*

*[Auditor's signature]*

*[Auditor's city and state]*

*[Date of the auditor's report]*

### Illustration 4—Unmodified Opinion on ICFR Making Reference to a Component Auditor

The following is an illustrative report expressing an unmodified opinion on ICFR when the engagement partner decides to make reference to the report of a component auditor.

#### **Independent Auditor's Report**

*[Appropriate Addressee]*

#### **Report on Internal Control Over Financial Reporting<sup>1</sup>**

We have audited ABC Company's internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*.<sup>2</sup>

#### ***Management's Responsibility for Internal Control Over Financial Reporting***

Management is responsible for designing, implementing, and maintaining effective internal control over financial reporting and for its assessment about the effectiveness of internal control over financial reporting included in the accompanying *[title of management's report]*.

#### ***Auditor's Responsibility***

Our responsibility is to express an opinion on the entity's internal control over financial reporting based on our audit. We did not audit the effectiveness of internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 percent and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 20XX. The effectiveness of B Company's internal control over financial reporting was audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other auditors. 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 effective internal control over financial reporting was maintained in all material respects.

An audit of internal control over financial reporting involves performing procedures to obtain audit evidence about whether a material weakness exists. The procedures selected depend on the auditor's judgment, including the assessment of the risks that a material weakness exists. An audit includes obtaining an understanding of internal control over financial reporting and testing and evaluating the design and operating effectiveness of internal control over financial reporting based on the assessed risk.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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<sup>1</sup> The subtitle "Report on Internal Control Over Financial Reporting" is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

<sup>2</sup> For example, the following may be used to identify the criteria: "criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."



***Definition and Inherent Limitations of Internal Control Over Financial Reporting***

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with *[applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]*. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with *[applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]*, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements. Also, projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

***Opinion***

In our opinion, based on our audit and the report of the other auditors, ABC Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*.

***Report on Financial Statements***

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the *[identify financial statements]* of ABC Company, and our report dated *[date of report, which should be the same as the date of the report on the audit of ICFR]* expressed *[include nature of opinion]*, based on our audit and the report of the other auditors.

***Report on Other Legal and Regulatory Requirements***

*[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]*

*[Auditor's signature]*

*[Auditor's city and state]*

*[Date of the auditor's report]*

### Illustration 5—Combined Report Expressing an Unmodified Opinion on ICFR and an Unmodified Opinion on the Financial Statements

The following is an illustrative combined report expressing an unmodified opinion on ICFR and an unmodified opinion on the financial statements. The circumstances include an audit of a complete set of general purpose financial statements (single year) prepared in accordance with accounting principles generally accepted in the United States of America.

#### **Independent Auditor's Report**

*[Appropriate Addressee]*

#### **Report on the Financial Statements and Internal Control<sup>1</sup>**

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements. We also have audited ABC Company's internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*.<sup>2</sup>

#### ***Management's Responsibility for the Financial Statements and Internal Control Over Financial Reporting***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of effective internal control over financial reporting relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. Management is also responsible for its assessment about the effectiveness of internal control over financial reporting, included in the accompanying *[title of management's report]*.

#### ***Auditor's Responsibility***

Our responsibility is to express an opinion on these financial statements and an opinion on the entity's internal control over financial reporting 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 audits to obtain reasonable assurance about whether the financial statements are free from material misstatement and whether effective internal control over financial reporting was maintained in all material respects.

An audit of financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the

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<sup>1</sup> The subtitle "Report on the Financial Statements and Internal Control" is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

<sup>2</sup> For example, the following may be used to identify the criteria: "criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

financial statements in order to design audit procedures that are appropriate in the circumstances. An audit of financial statements also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

An audit of internal control over financial reporting involves performing procedures to obtain evidence about whether a material weakness exists. The procedures selected depend on the auditor's judgment, including the assessment of the risk that a material weakness exists. An audit of internal control over financial reporting also involves obtaining an understanding of internal control over financial reporting and testing and evaluating the design and operating effectiveness of internal control over financial reporting based on the assessed risk.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

***Definition and Inherent Limitations of Internal Control Over Financial Reporting***

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements. Also, projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

***Opinions***

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America. Also, in our opinion, ABC Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*.

**Report on Other Legal and Regulatory Requirements**

*[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]*

*[Auditor's signature]*  
*[Auditor's city and state]*  
*[Date of the auditor's report]*

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## Exhibit B—Illustrative Written Communication of Significant Deficiencies and Material Weaknesses

The following is an illustrative written communication of significant deficiencies and material weaknesses.

To Management and *[identify the body or individuals charged with governance, such as the entity's board of directors]* of ABC Company:

In connection with our audit of ABC Company's (the Company) financial statements as of December 31, 20XX, and for the year then ended, and our audit of the Company's internal control over financial reporting as of December 31, 20XX (integrated audit), auditing standards generally accepted in the United States of America require that we advise you of the following matters relating to internal control over financial reporting (internal control) identified during our integrated audit.

Our responsibility is to plan and perform our integrated audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether due to fraud or error, and whether effective internal control was maintained in all material respects (that is, whether material weaknesses exist as of the date specified in management's assessment). The integrated audit is not designed to detect deficiencies that, individually or in combination, are less severe than a material weakness.

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

*[Describe the material weaknesses that were identified during the integrated audit and provide an explanation of their potential effects. The auditor may separately identify those material weaknesses that exist as of the date specified in management's assessment about ICFR by referring to the auditor's report.]*

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

*[Describe the significant deficiencies that were identified during the integrated audit and provide an explanation of their potential effects.]*

This communication is intended solely for the information and use of management, *[identify the body or individuals charged with governance]*, others within the organization, and *[identify any governmental authorities to which the*

*auditor is required to report*] and is not intended to be and should not be used by anyone other than these specified parties.<sup>1</sup>

[Auditor's signature]

[Auditor's city and state]

[Date]

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<sup>1</sup> When the engagement is also performed in accordance with *Government Auditing Standards*, see paragraph .11 of section 905, *Alert That Restricts the Use of the Auditor's Written Communication*, for alternative reporting requirements.

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## Exhibit C—Illustrative Management Report

The following is an illustrative management report containing the reporting elements described in paragraph .55 of this section with no material weaknesses reported.

### Management's Report on Internal Control Over Financial Reporting

ABC Company's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with *[applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]*. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with *[applicable financial reporting framework, such as accounting principles generally accepted in the United States of America]*, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction, of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Management of ABC Company is responsible for designing, implementing, and maintaining effective internal control over financial reporting. Management assessed the effectiveness of ABC Company's internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*.<sup>1</sup> Based on that assessment, management concluded that, as of December 31, 20XX, ABC Company's internal control over financial reporting is effective, based on *[identify criteria]*.

Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements. Also, projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

ABC Company  
Report signers, if applicable  
Date

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<sup>1</sup> For example, the following may be used to identify the criteria: "criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

.A157

## Exhibit D—Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act

1. The Federal Deposit Insurance Corporation (FDIC) has provided guidance on the meaning of the term *financial reporting* for purposes of compliance by insured depository institutions (IDIs) with Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) (Section 36 of the Federal Deposit Insurance Act [FDI Act], 12.U.S.C. 1831m), and its implementing regulation, 12 CFR Part 363. The FDIC's guidance indicates that financial reporting, at a minimum, includes both financial statements prepared in accordance with generally accepted accounting principles (GAAP) for the IDI (or its holding company) and financial statements prepared for regulatory reporting purposes. Financial statements prepared for regulatory reporting purposes include the schedules equivalent to the GAAP-based financial statements that are included in an IDI's (or its holding company's) appropriate regulatory report (for example, Schedules RC, RI, and RI-A in the Consolidated Reports of Condition and Income [Call Report]). Accordingly, to comply with the FDICIA and Part 363, management of the IDI (or its holding company) and the auditor are required to identify and test controls over the preparation of GAAP-based financial statements as well as the schedules equivalent to the GAAP-based financial statements that are included in the IDI's (or its holding company's) appropriate regulatory report. Further, both management and the auditor are required to include in their report on the IDI's (or its holding company's) internal control over financial reporting (ICFR) a specific description indicating that the scope of ICFR included controls over the preparation of the IDI's (or its holding company's) GAAP-based financial statements as well as the schedules equivalent to the GAAP-based financial statements that are included in the IDI's (or its holding company's) appropriate regulatory report.<sup>1</sup>

### Definition of ICFR for FDICIA Purposes

2. In accordance with paragraph .64 of this section, the auditor's report is required to include a definition of ICFR that uses the same description of ICFR that management uses in its report. The following is an illustrative definition paragraph that may be used when an IDI that is an insured bank (which is not subject to Section 404 of the Sarbanes-Oxley Act of 2002) elects to report on controls for FDICIA purposes at the bank holding company level:

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. Because management's assessment and our audit were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), our audit of [Holding Company's] internal control over financial reporting included controls over the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and with the instructions to the Consolidated Financial Statements for Bank Holding

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<sup>1</sup> Refer to Section 36 of the Federal Deposit Insurance Act (FDI Act), Section 363.1: Scope and Definitions, for the requirements pertaining to compliance by subsidiaries of holding companies.

Companies (Form FR Y-9C).<sup>2</sup> An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

#### **Requirements When the IDI Is Required to Report on ICFR at the IDI Level**

3. This paragraph and the following paragraphs are applicable and provide guidance when an IDI is required by 12 CFR Part 363 to report on ICFR at the IDI level. An IDI that is a subsidiary of a holding company may use the consolidated holding company's financial statements (group financial statements) to satisfy the audited financial statements requirement of 12 CFR Part 363, provided certain criteria are met.<sup>3</sup> For some IDIs, however, an audit of ICFR is required at the IDI level. An audit of ICFR is required to be integrated with an audit of financial statements. Accordingly, to comply with the integrated audit requirements in this section, when the IDI elects to use the holding company's group financial statements to satisfy the audited financial statements requirement of 12 CFR Part 363 and the audit of ICFR is required to be performed at the IDI level, the auditor would be required to perform procedures necessary to obtain sufficient appropriate audit evidence to enable the auditor to express an opinion on the IDI's financial statements and on its ICFR. When the IDI does not prepare financial statements at the IDI level for external distribution, "financial statements" for this purpose may consist of the IDI's financial information in a reporting package or equivalent schedules and analyses that include the IDI information necessary for the preparation of the holding company's group financial statements, including disclosures. The measurement of materiality is determined based on the IDI's financial information rather than the holding company's group financial statements.<sup>4</sup> If the auditor is unable to apply the procedures necessary to obtain sufficient appropriate audit evidence with respect to the IDI's financial information, the auditor is required by paragraph .73 of this section to withdraw from the engagement or disclaim an opinion on the effectiveness of ICFR at the IDI level.

#### **Evaluation of IDI Financial Reporting Process**

4. As previously described, the FDIC indicated that financial reporting, at a minimum, includes both financial statements prepared in accordance with generally accepted accounting principles (GAAP) for the IDI (or its holding company) and financial statements prepared for regulatory purposes. Financial statements prepared for regulatory reporting purposes include the schedules equivalent to the GAAP-based financial statements that are included in an IDI's

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<sup>2</sup> This sentence would be modified if the insured depository institution (IDI) reports at the institution level rather than at the bank holding company level to refer to the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income instead of to the Form FR Y-9C. This sentence would also be modified if the IDI reports at a holding company level and employs another approach to reporting on controls over the preparation of regulatory reports as permitted by Section 36 of the FDI Act.

<sup>3</sup> See footnote 1.

<sup>4</sup> See paragraph .10 of section 320, *Materiality in Planning and Performing an Audit*.



(or its holding company's) appropriate regulatory report. When the IDI does not prepare financial statements for external distribution, the auditor is, nevertheless, required by paragraph .24 of this section to evaluate the IDI's period-end financial reporting process. This process includes, among other things, the IDI's procedures for preparing financial information for purposes of the holding company's group financial statements, which are prepared in accordance with GAAP, and the schedules equivalent to the GAAP-based financial statements that are included in the IDI's appropriate regulatory report.

#### **Organization Structure**

5. The period-end financial reporting process may occur either at the IDI or the holding company, or both. The organizational structure, including where the controls relevant to the IDI's financial information operate, may affect how the auditor evaluates this process. For example

- a. when the period-end financial reporting process occurs at the holding company and the IDI comprises substantially all of the consolidated total assets, there may be no distinguishable difference between the IDI's and its holding company's process for purposes of the integrated audit. This is because the auditor's risk assessment, including the determination of significant classes of transactions, account balances, and disclosures, and their relevant assertions, the selection of controls to test, and the determination of the evidence necessary to conclude on the effectiveness of a given control, would likely be the same for the IDI and the holding company.<sup>5</sup> In this circumstance, the period-end financial reporting process of the holding company would be, in effect, the period-end financial reporting process of the IDI and, therefore, would be included in the scope of the integrated audit of the IDI.
- b. when the period-end financial reporting process occurs at the holding company and the IDI does not comprise substantially all of the consolidated total assets, the IDI's financial reporting process may be sufficient for the auditor to meet the requirement in paragraph .24 of this section, if the necessary GAAP information is prepared by the IDI or the holding company, and the process can be evaluated by the auditor. The auditor may determine that the IDI's preparation of the IDI's appropriate regulatory report, together with other financial information at the IDI level that is incorporated into the holding company's group financial statements, is sufficient for this purpose. In this circumstance, both the period-end financial reporting process of the holding company, as it relates to the financial information of the IDI, and the period-end financial reporting process of the IDI, with respect to the preparation of the schedules equivalent to the basic financial statements that are included in the IDI's appropriate regulatory report, would be included in the scope of the integrated audit of the IDI.

#### **IDI Not Subject to Section 404 of Sarbanes-Oxley Act of 2002**

6. The illustrative reports in exhibit A, "Illustrative Reports," of this section may be used to report on the effectiveness of the IDI's ICFR. Because 12 CFR Part 363 does not require the auditor to issue a separate auditor's report on the IDI's financial statements, the requirement in paragraph .65 of this section to add an other-matter paragraph to the ICFR report that references the financial

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<sup>5</sup> See paragraph .A22 of this section.

statement audit will not apply when the auditor does not issue a separate auditor's report on the IDI's financial statements. In accordance with paragraph .64 of this section, the auditor's report on ICFR is required to include a definition of ICFR that uses the same description of ICFR as management uses in its report. The following is an illustrative definition paragraph that may be used when an IDI that is not subject to Section 404 of the Sarbanes-Oxley Act of 2002 is required to report on controls for FDICIA purposes at the IDI level, and the IDI uses the holding company's group financial statements to satisfy the audited financial statements requirement of 12 CFR Part 363:

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with generally accepted accounting principles. Because management's assessment and our audit were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), our audit of [IDI's] internal control over financial reporting included controls over the preparation of financial information for purposes of [consolidated holding company's] financial statements in accordance with accounting principles generally accepted in the United States of America and controls over the preparation of schedules equivalent to basic financial statements in accordance with the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income (Call Report Instructions). An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

#### **Use of the *Internal Control—Integrated Framework* (2013) (COSO)**

7. Management may evaluate and report on the effectiveness of the IDI's ICFR based on the report *Internal Control—Integrated Framework* (2013), issued by Committee of Sponsoring Organizations of the Treadway Commission's (COSO). For purposes of reporting under Section 112 of FDICIA, the COSO criteria relevant to internal reporting objectives are appropriate only for the IDI and its regulatory agencies that are presumed to have an adequate understanding of the level of the auditor's service on historical financial information, considering the IDI does not prepare external GAAP-based financial statements. Accordingly, the report is required to include an other-matter paragraph, under an appropriate heading, that restricts its use.<sup>6</sup> An example of such a restriction is as follows:

#### ***Restriction on Use***<sup>7</sup>

This report is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the organization, the Federal Deposit Insurance Corporation and [other federal bank

<sup>6</sup> See paragraphs .06a and .07 of section 905, *Alert That Restricts the Use of the Auditor's Written Communication*. Although reports on internal control issued in accordance with the guidance in this appendix are required to be restricted as to use, Section 36 of the FDI Act and Title 12 U.S. Code of Federal Regulations Part 363 require that these reports be available for public inspection.

<sup>7</sup> Another appropriate heading may be used.

*regulatory agency*] and is not intended to be and should not be used by anyone other than these specified parties.

8. Likewise, the auditor's report and management's assessment about ICFR refer to the COSO criteria relevant to internal reporting objectives. For example, the following may be used to identify the criteria: "criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) relevant to internal reporting objectives for the express purpose of meeting the regulatory requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA)."

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