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Companion to PPC's Guide to

Compilation and Review Engagements

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Interactive Self-study CPE

Companion to PPC's Guide to Compilation and Review Engagements

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INTRODUCTION

Companion to PPC's Guide to Compilation and Review Engagements consists of three interactive self-study CPE courses. These are companion courses to *PPC's Guide to Compilation and Review Engagements* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **cl.thomsonreuters.com/ogs** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **July 31, 2018**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit.

Taking the Courses

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

Qualifying Credit Hours—NASBA Registry (QAS Self-Study)

Checkpoint Learning is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be submitted to the National Registry of CPE Sponsors through its website: **www.nasbaregistry.org**.

Checkpoint Learning is also approved for "QAS Self Study" designation.

The requirements for NASBA Registry membership include conformance with the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. Each course is designed to comply with the *Standards*. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the **Overview** page before each course.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

Online Grading. Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam of $89 is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Test Instructions preceding the **Examination for CPE Credit**. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

Print Grading. You can receive CPE credit by emailing, mailing, or faxing your completed **Examination for CPE Credit Answer Sheet** to Thomson Reuters (Tax & Accounting) Inc. for grading. Answer sheets are located at the end of all course materials. Answer sheets may be printed from electronic products; they can also be scanned for email grading, if desired. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for each course. Payment (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. Payment for emailed or faxed answer sheets is $89. There is an additional $10 charge for manual print grading, so please include a total of $99 with answer sheets sent by regular mail. Please take a few minutes to complete the **Self-study Course Evaluation** so that we can provide you with the best possible CPE.

You may fax your completed **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation** to **(888) 286-9070** or email them to *CPLGrading@thomsonreuters.com*. The mailing address is provided on the Overview and Exam Instructions pages.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet.** Payment must accompany each answer sheet submitted ($89 when sent by email or fax; $99 when sent by regular mail). We would also appreciate a separate **Self-study Course Evaluation** from each person who completes an examination.

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COMPANION TO PPC'S GUIDE TO COMPILATION AND REVIEW ENGAGEMENTS

COURSE 1

FORM AND PRESENTATION OF FINANCIAL STATEMENTS, PARTNERSHIPS, AND S CORPORATIONS (CARTG171)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course takes a look at several issues related to compilation and review engagements. Lesson 1 discusses the form and presentation of financial statements. Lesson 2 examines issues related to partnerships. Lesson 3 concludes the course with a discussion of issues related to S corporations.

PUBLICATION/REVISION DATE: July 2017

RECOMMENDED FOR: Users of *PPC's Guide to Compilation and Review Engagements*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of accounting

CPE CREDIT: 7 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

FIELD OF STUDY: Accounting

EXPIRATION DATE: Postmark by **July 31, 2018**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Form and Presentation of Financial Statements

Completion of this lesson will enable you to:

- Identify appropriate presentation options for the title page, table of contents, and the accountant's report, and basic financial statements, as well as specific considerations for the balance sheet, income statement, and comprehensive income.
- Recognize best practices for how statements of retained earnings or changes in stockholders' equity, the statement of cash flows, the summary of significant accounting policies, and the notes to the financial statements should be presented.
- Identify how to address the presentation of supplementary information, risks and uncertainties, derivative instruments, accounts receivable, and fiscal year changes.
- Determine appropriate best practices related to consolidating variable interest entities; uncertain tax positions; financial statements that are consolidated, consolidating, or combined; fair value measurements, and materiality.

Lesson 2—Partnerships

Completion of this lesson will enable you to:

- Determine how partnerships deal with a variety of issues, including selecting an accounting basis, preparing financial statements using the contractual basis of accounting, federal income taxes, state income and franchise taxes, guaranteed payments to partners, loans between partners and the partnership, the equity section of the balance sheet, statements of changes in partners' capital, changes in partnership interest, investments in partnerships and joint ventures, partnership retirement plans, and changes in legal form of entity.
- Identify the advantages and disadvantages and related accounting and reporting issues of limited liability companies and limited liability partnerships.

Lesson 3—S Corporations

Completion of this lesson will enable you to:

- Recognize appropriate financial statement presentation for S corporations, as well as procedures they may use to account for retained earnings.
- Identify the effects of losses, tax/book differences, and termination on an S corporation's retained earnings account.

TO COMPLETE THIS LEARNING PROCESS:

Submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

- Email to: *CPLGrading@thomsonreuters.com*
- Fax to: **(888) 286-9070**
- Mail to:

Thomson Reuters
Tax & Accounting—Checkpoint Learning
CARTG171 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

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

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Form and Presentation of Financial Statements

INTRODUCTION

This lesson discusses and illustrates general form and presentation guidelines for compiled and reviewed financial statements of GAAP corporations. Many of these guidelines also apply to financial statements prepared in accordance with AR-C 70. An in-depth discussion of AR-C 70, as well as general form and presentation issues unique to noncorporate business entities and special purpose frameworks is beyond the scope of this course. More information on those topics can be found in *PPC's Guide to Compilation and Review Engagements.*

The form and presentation issues discussed in this lesson are divided into sections that represent the following main components of a bound set of financial statements.

a. Title Page

b. Table of Contents

c. Accountant's Report

d. Basic Financial Statements

e. Summary of Accounting Policies (unless included as part of the notes to the financial statements)

f. Notes to Financial Statements

g. Supplementary or Other Information

Before proceeding to the general discussions that follow, it is important to note that preparing financial statements is both an art and a science, normally learned by trial and error or by word of mouth, but never completely mastered. It is an art in that financial statements must be presented in a format that has eye appeal, is understandable, conveys a company's financial picture, and can be produced economically. It is a science in that it requires the mastery of a complex array of authoritative standards for measurement, presentation, and disclosure. This course addresses the subject matter in general terms. If more in-depth information is required, practitioners may also want to consult the guidance found in *PPC's Guide to Preparing Financial Statements*.

For consistency, this course uses the financial statement formats and style policies from *PPC's Guide to Preparing Financial Statements*. There are also CPE courses available associated with *PPC's Guide to Preparing Financial Statements*. They can be accessed on **cl.thomsonreuters.com**.

When preparing financial statements, the accountant should consider materiality, which is discussed later in this lesson.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify appropriate presentation options for the title page, table of contents, and the accountant's report, and basic financial statements, as well as specific considerations for the balance sheet, income statement, and comprehensive income.
- Recognize best practices for how statements of retained earnings or changes in stockholders' equity, the statement of cash flows, the summary of significant accounting policies, and the notes to the financial statements should be presented.

- Identify how to address the presentation of supplementary information, risks and uncertainties, derivative instruments, accounts receivable, and fiscal year changes.
- Determine appropriate best practices related to consolidating variable interest entities; uncertain tax positions; financial statements that are consolidated, consolidating, or combined; fair value measurements, and materiality.

THE TITLE PAGE

General

A title page is recommended for all financial statement presentations. The title page should contain the name of the company, the title of the financial statements, and the date or period covered, as illustrated below.

XYZ CORPORATION

FINANCIAL STATEMENTS

Years Ended December 31, 20X2 and 20X1

Name of Company

The name of the company should be presented exactly as listed in the charter, partnership agreement, or other appropriate legal document. When the company is not a regular corporation, the type of legal entity should be disclosed. A best practice would be to provide parenthetical disclosure in the accountant's report. Examples of appropriate presentations of the name of the entity are as follows:

a. ABC CORPORATION

b. XYZ LTD.

c. JONES NURSERY

d. THE ESTATE OF JOHN DOE

e. MR. AND MRS. JOHN Q. PUBLIC

f. JANE DOE TESTAMENTARY TRUST

Title of Financial Statements

If the presentation includes more than one type of financial statement (e.g., Balance Sheet, Statement of Income and Retained Earnings, and Statement of Cash Flows), the term *Financial Statements* is the most practical method of communicating to the reader what is included in the presentation. When only one type of statement is presented, it is more appropriate to use the exact title of the statement as follows:

BALANCE SHEET or STATEMENT OF INCOME

When consolidated or combined financial statements are presented, the title page should include the words *consolidated* or *combined*, as in the following examples:

a. CONSOLIDATED FINANCIAL STATEMENTS

b. COMBINED BALANCE SHEET

c. CONSOLIDATED STATEMENT OF INCOME AND RETAINED EARNINGS

If comparative periods are presented in a package that contains only one type of statement, the title should appear as follows:

BALANCE SHEETS or STATEMENTS OF INCOME

When financial statements include supplementary or other information, the title should be modified as follows:

FINANCIAL STATEMENTS AND SUPPLEMENTARY
(OR OTHER FINANCIAL) INFORMATION

Some practitioners add a description of the service performed to the title of the financial statements on the title page as follows:

XYZ CORPORATION

COMPILED FINANCIAL STATEMENTS

Years Ended December 31, 20X2 and 20X1

However, the policy adopted for all PPC companion guides is to omit a description of the service from the title except when different levels of service are performed, as discussed later in this lesson.

Date or Period Covered

When both a balance sheet and statement of income are presented, the period covered by the statement (or statements) of income should be shown on the title page as follows:

a. Years Ended December 31, 20X2 and 20X1

b. Three Months Ended March 31, 20X2 and 20X1

c. Six Months Ended June 30, 20X2

d. One Month and Six Months Ended June 30, 20X2

The last day of the month should be used even if that date falls on a Sunday or holiday, except in circumstances such as the following:

a. Entities on a 52/53 week accounting period:

   (1) Years Ended December 27, 20X2 (52 weeks) and January 3, 20X2 (53 weeks)

   (2) Year (52 weeks) Ended January 2, 20X2

b. Entities using 13-week quarters:

   Quarters (13 weeks) Ended March 29, 20X2 and March 27, 20X1

c. Initial financial statements for new entities:

   From January 23, 20X1 (Date of Inception) to March 31, 20X1

d. Financial statements for liquidating entities:

   From January 1, 20X1 to September 17, 20X1 (Date of Liquidation)

When only balance sheets are presented, the date of the statements would appear as follows:

December 31, 20X2 and 20X1

Different Levels of Service—Comparative Financial Statements

Comparative financial statements may include one period that is audited and another period that is unaudited. The title page may indicate the level of service when this occurs as follows:

XYZ CORPORATION

FINANCIAL STATEMENTS

Years Ended December 31, 20X2 (Audited) and 20X1 (Unaudited)
or
Years Ended December 31, 20X2 (Unaudited) and 20X1 (Audited)

The parenthetical notes can be changed to say "Compiled" or "Reviewed," as appropriate.

THE TABLE OF CONTENTS

A table of contents may not be useful to the reader of financial statement presentations unless supplementary information is included. If a table of contents is presented, the title of each statement or schedule should be listed in the table of contents exactly as it appears on the statement or schedule.

THE ACCOUNTANT'S REPORT

General

This lesson does not discuss the wording of the accountant's compilation or review report and other considerations that affect the degree of responsibility assumed by the accountant, as the scope of this lesson focuses on presentation and format. Information about the content of such reports is available in *PPC's Guide to Compilation and Review Engagements*. *PPC's Guide to Auditor's Reports* discusses and illustrates auditor's reports. This part of Lesson 1 discusses presentation and format considerations for the accountant's report. A discussion of referencing to the accountant's report appears later in this lesson.

This section applies only when the accountant issues a compilation or review report. Guidance on the legend in a preparation service is provided later in this lesson.

Letterhead

There is no requirement that the accountant's report be printed on the firm's letterhead (nor is there any SSARS requirement for the accountant's report be manually signed or that the financial statements be bound). Consequently, the report can be presented on plain stationery without letterhead. However, it is a best practice for the accountant's report to be presented on the firm's letterhead. The use of letterhead adds the formality that reflects the professional approach to association with financial statements. Practitioners may use software packages that generate the appropriate accountant's report, which may be difficult to print on firm letterhead. In these situations, the accountant can enhance the professional appearance of the product by binding the software-generated statements and report in report covers containing the firm name and logo. Alternatively, the practitioner may take the system-generated report and photocopy it onto the firm's letterhead if it is difficult to have the system print the report directly onto the firm's letterhead. Note also that if the firm letterhead used for printing the accountant's report indicates the city and state of the office issuing the accountant's report, the requirement at AR-C 80.A26 and AR-C 90.A77 to include that information is met.

Title of Accountant's Report

The SSARS (AR-C 80) do not contain a requirement for the accountant's compilation report to include a title. However, nothing precludes an accountant from including a title in a SSARS compilation report, if so desired. The accountant may indicate that he or she is independent in the title, if a title is used.

AR-C 90.39a requires the accountant's review report to include a title that clearly indicates that it is the accountant's review report and includes the word *independent*. An appropriate title would be—

- INDEPENDENT ACCOUNTANT'S REVIEW REPORT.

A minor point, but of interest to some, is the placement of the apostrophe in *Accountant's*. Many accountants have questioned whether to use singular or plural terminology when referring to themselves as they report on reviewed or compiled financial statements. While there is no authoritative guidance on this issue, the AICPA has issued an AICPA *Technical Question and Answer* (Q&A 9160.25) that addresses how to determine which term to use. According to the Q&A, sole practitioners often use singular terms; firms that have only one partner and professional staff may use the singular term or the plural term; and firms that have more than one partner most often use the plural term. The use of singular or plural references to the accountant is up to the accountant. For ease of report preparation, consistency in the use of singular or plural term in all reports is recommended.

Address

The SSARS (AR-C 80) do not contain a requirement for compilation reports to include an addressee, but does for review reports (AR-C 90.39b). However, nothing precludes an accountant from including an addressee in a SSARS compilation report, if so desired. Generally, the accountant's report is addressed to management, but may be addressed to the Board of Directors or Stockholders. Reports are not intended as letters. Accordingly, addresses that include street names and zip codes are not appropriate. Many firms also omit the city and state in the address, especially when the report is addressed to stockholders who are widely dispersed. Examples of appropriate addresses follow:

a. To Management
XYZ Corporation
Philadelphia, Pennsylvania

b. To the Stockholders
XYZ Corporation

Examples of addresses that may be appropriate for entities other than corporations are as follows:

a. Closely held company:

Mr. John Small
Small Manufacturing, Inc.
Monroe, Louisiana

b. Personal financial statements:

Mr. and Mrs. John P. Doe
Los Angeles, California

c. Partnerships:

(1) To the Managing Partner
ABC Company
New York, New York

or

(2) Ms. Barbara J. Greene
General Partner
XYZ Ltd. Partnership
Austin, Texas

d. Proprietorship financial statements:

Mr. John J. Jones
Jones Funeral Parlor
Tampa, Florida

e. Trust financial statements:

Mr. John T. Smith
Trustee
Mary B. Doe Testamentary Trust
Detroit, Michigan

f. Estate financial statements:

Mr. George S. Clark
Executor
Estate of John P. Doe
Columbus, Ohio

Salutations

Common practice in the profession is to exclude salutations such as "Dear Sirs" or "Gentlemen" from the accountant's report.

Signature

AR-C 80.17g requires that compilation reports contain a signature of the accounting firm or the accountant, as appropriate. AR-C 90.39g also requires that review reports contain a signature of the accounting firm or the accountant, as appropriate. SSARS No. 23 removed the application guidance concerning signing the accountant's compilation report; thus, the SSARS are silent on how the report may be signed. This course suggests that the signature placed on a compilation or review report can be manual, printed, or digital.

It is common practice to omit complimentary closings such as "Sincerely" or "Very truly yours" and to sign the report with the firm's signature rather than an individual's signature unless the accountant is a sole practitioner. These practices add formality to the accountant's report. However, certain state boards of accountancy require the individual signature of a shareholder if the firm is a professional corporation. Likewise, certain regulatory agencies require signature by the individual engagement partner. Signatures are seldom followed by the title "Certified Public Accountant" since, in most cases, the letterhead will include the title.

Reference to Office Location

AR-C 80.17h and AR-C 90.39h require the accountant's compilation and review reports to name the city and state where the accountant practices. There is no requirement regarding the placement of the city and state on the report. The illustrative reports in the SSARS show the city and state after the signature of the accountant or accounting firm and before the date of the accountant's report. In addition, AR-C 80.A26 and AR-C 90.A77 note that the city and state may be included in the letterhead of the report.

Date of Report

The date of the report affects the responsibility assumed by the accountant. The format of the date is rather straightforward except when dual dating is necessary. Examples of date formats are as follows:

a. March 3, 20X2

b. March 3, 20X2 (except for Note D, which is as of April 20, 20X2)

The illustrative reports in the SSARS precede the date with the office's location that issued the report, for example:

> Midland, Texas
> March 31, 20X2

Periods Covered

Generally, the periods covered in the accountant's report should agree with the periods covered in the financial statements' headings. However, when reporting on comparative *interim* financial statements for different periods, some accountants refer to the periods covered in the accountant's report as "the periods then ended" rather than to the specific periods covered. For example, a report on financial statements covering the one month and nine months ended September 30, 20XX, might refer to the "balance sheet of XYZ Company as of September 30, 20XX, and the related statement of income and retained earnings *for the periods then ended*." While this is not technically correct, it may be a practical necessity, particularly if the accountant is using a software package that is set up this way and cannot be easily modified. It seems likely that such a report would not be misleading as long as the related statements of income, retained earnings, and cash flows specify the periods covered in the financial statements' headings.

Use of "I" versus "We" in Accountant's Report

Many accountants have questioned whether to use the singular (*I*) or plural (*We*) when referring to themselves in the accountant's compilation or review report. The discussion earlier in this section regarding the placement of the apostrophe in *Accountant's* also provides guidance in determining a suitable pronoun to use.

BASIC GAAP FINANCIAL STATEMENTS

What Are They?

The basic financial statements included in the typical GAAP financial statement presentation are:

a. Balance Sheet.

b. Statement of Income.

c. Statement of Comprehensive Income.

d. Statement of Retained Earnings or Changes in Stockholders' Equity.

e. Statement of Cash Flows.

The typical presentation also includes descriptions of accounting policies and notes to financial statements. Form and presentation considerations for each of these items is discussed in more detail in the sections that follow. *PPC's Guide to Preparing Financial Statements* expands on the form and presentation of financial statements and provides comprehensive guidance regarding the application of GAAP to each component of the financial statements.

Comparative Financial Statements

Although they are not required, FASB ASC 205-10-45-1 clearly states that *comparative financial statements enhance the usefulness of statements and are therefore preferable*. When comparative financial statements are presented, the notes should include data for prior years to the extent that they continue to be of significance, and the accountant's report should cover all years. When the manner or basis of presenting items has changed because of reclassification or other reasons, an explanation of the change should be made in the statements. If the change is caused by correction of an error or by an accounting change, the practitioner should refer to FASB ASC 250-10.

Heading Financial Statements

The heading of each financial statement should include the legal name of the company, the title of the specific statement, and the date or period covered.

Reference to Accountant's Report

The SSARS do not have a requirement for a reference to the accountant's report to be included on each page of the financial statements. However, AR-C 80.A24 and AR-C 90.A66 both indicate that the accountant may consider including a reference such as "See accountant's compilation report," "See independent accountant's compilation report," or "See independent accountant's review report" on each page of the financial statements to the accountant's report in compiled and reviewed financial statements in order to avoid an unintended level of reliance on the financial statements if the report were to become unattached from the statements.

For ease of production, some accountants may prefer using the generic "See accountant's report" regardless of whether the financial statements are compiled or reviewed and regardless of whether the accountant is independent or not. This general reference helps reduce both clerical and professional time. In addition, the likelihood of referencing errors is also eliminated.

If the statements include notes, the generic reference can be expanded to include the notes and to read:

> See accompanying notes and accountant's report.

Reference to the notes could also be added to the more specific references discussed above, if the accountant chooses to use one of these references instead. Although the reference to accompanying notes is not required by the SSARS, including such a reference seems to be a common practice for accountants if the financial statements include notes. However, because there is not a requirement to include a reference to the accountant's report, the financial statements illustrated in this course do not illustrate references to the accountant's report.

Legend for Prepared Financial Statements

AR-C 70 allows the accountant to prepare financial statements without issuing an accountant's report. To avoid any inappropriate reliance on the accountant's work, AR-C 70.14 requires each page of the financial statements to include a statement indicating no assurance has been provided on the financial statements. This can be done with the use of a legend with wording such as, "No assurance is provided on these financial statements."

Use of "Unaudited"

The financial statement title is sometimes followed parenthetically with "Unaudited." This is not required by the SSARS, but some accountants prefer such disclosure to emphasize that compiled or reviewed statements are unaudited. [In addition, Q&A 9150.04 of the AICPA *Technical Questions and Answers* provides guidance on this subject by emphasizing that SSARS do not require that each page of compiled or reviewed financial statements of a nonissuer be marked as "unaudited."] Except as described below, this is not done in any illustrated financial statements in this course or in *PPC's Guide to Compilation and Review Engagements*.

Different Levels of Service

When issuing comparative financial statements, the level of service provided for each period may differ. *If both periods are unaudited*, but one is compiled and the other reviewed, the level of service for each period can be indicated parenthetically after the date in the heading of the statement.

> XYZ CORPORATION
> BALANCE SHEETS
> December 31, 20X2 (Reviewed) and 20X1 (Compiled)

Disclosure if one of the periods is audited and the other unaudited may be made either in the statement headings or column headings. Disclosure in the statement heading would be as follows:

XYZ CORPORATION
BALANCE SHEETS
December 31, 20X2 (Audited) and 20X1 (Unaudited)

or

December 31, 20X2 (Unaudited) and 20X1 (Audited)

"Compiled" or "Reviewed" could be substituted for "Unaudited," if preferred.

Disclosure in the column headings would be as follows:

XYZ CORPORATION
BALANCE SHEETS
December 31, 20X2 and 20X1

	20X2 (Audited)	20X1 (Unaudited)
ASSETS		
CURRENT ASSETS		
Cash	$ XXX	$ XXX
Accounts receivable, etc.	$ XXX	$ XXX

THE BALANCE SHEET

Balance Sheet Title

In practice, the most widely used title is *balance sheet*, and that is the term used throughout this lesson. However, *statement of financial position* also is acceptable.

In certain situations, however, neither term is appropriate. Those terms are reserved for statements that purport to present financial position in accordance with GAAP and should not be used with statements that are presented on a special purpose framework, such as the tax or cash basis.

FASB ASC 274-10-45-4 recommends that for personal financial statements the balance sheet be titled "Statement of Financial Condition."

Balance Sheet Format

The balance sheet may appear in *account form (side-by-side format)* with assets on the left-hand side of the statement and liabilities and stockholders' equity on the right-hand side. This report format is often presented on two facing pages. Alternatively, it may appear in report form (*running format*) with assets at the top of the page and liabilities and stockholders' equity at the bottom. This report format is generally presented on one page.

Classification of Debt

If a classified balance sheet is presented, long-term loan agreements need to be analyzed to determine appropriate classification as either a current or long-term liability. In January 2017, the FASB issued a proposed ASU, *Debt (Topic 470): Simplifying the Classification of Debt in a Classified Balance Sheet (Current versus Noncurrent),* which would impact the classification of debt. As of the date of this course, the FASB was re-deliberating the comments received on the exposure draft and had not indicated a possible effective date for a final ASU. The project may be monitored at **www.fasb.org.** *PPC's Guide to Preparing Financial Statements* provides an in-depth discussion of the classification of debt.

THE INCOME STATEMENT

Title of Statement of Income

Alternative titles for presentation of an income statement include:

a. Statement of Income.

b. Income Statement.

c. Statement of Earnings.

d. Statement of Operations.

The title "Statement of Operations" or "Statement of Income (Loss)" may be used when the company has incurred a loss during the reporting period. However, many practitioners continue to use the title "Statement of Income" when a loss occurs.

Income Statement Format

The income statement may be presented in either the multiple-step form, the single-step form, or the modified single-step form. The multiple-step form shows several intermediate stages of income that may or may not have particular significance. The single-step statement lists and subtotals all income and credit items first, followed by a listing of all costs, expenses, and debit items (including income taxes) with a subtotal. The difference between the two subtotals represents the net results of operations for the period. The modified single-step form sets forth income before taxes, from which income taxes are deducted to arrive at net income.

Revenue and Expense Recognition

Generally, under currently effective accounting guidance, the standards for recognition of revenues and expenses may be stated as follows:

a. Revenue is recognized when a sale is complete (i.e., when a product is delivered, or a service performed and collection is reasonably assured).

b. Expense is recognized when the related revenue is recognized if the cost is clearly associated with the revenue, or in the period incurred if the cost provides no discernible future benefit.

Those statements provide a reasonable general description. However, in currently effective authoritative accounting standards and in accepted industry practice, there are many variations and refinements. For example, all of the following are generally accepted ways of recognizing revenue in defined circumstances: sale of product, substantial performance of service, percentage of completion, cost recovery, and installment basis. When performing a compilation or a review, the accountant obtains an understanding of the entity and its environment and an important part of that understanding is knowledge of the relevant accounting practices.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The ASU introduces a comprehensive, principles-based framework for recognizing revenue. The new revenue guidance introduces FASB ASC 606 and supersedes the revenue recognition requirements in FASB ASC 605 and most industry-specific revenue guidance in the FASB ASC. In August 2015, ASU 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, was issued to defer the original effective date of ASU 2014-09 by one year. ASU 2014-09 and related amendments to FASB ASC 606 are effective for nonpublic entities for years beginning after December 15, 2018, and interim periods within years beginning after December 15, 2019. Although a nonpublic entity may elect to apply the guidance earlier, the earliest it may be applied is for a year beginning after December 15, 2016, and interim periods within that year.

PPC's Guide to Preparing Financial Statements and *PPC's Guide to Revenue Recognition* both provide an overview of FASB ASC 606's core principle, the five step approach to achieve the core principle, and the extensive disclosure requirements.

PRESENTING COMPREHENSIVE INCOME

FASB ASC 220-10, *Comprehensive Income*, requires comprehensive income and its components to be reported when a company presents a full set of financial statements that report financial position, results of operations, and cash flows. The ASC establishes standards for reporting and presenting comprehensive income and its components in a basic set of financial statements. The following paragraphs provide a definition of comprehensive income and a brief discussion of certain related classification and presentation issues. An in-depth discussion of comprehensive income is beyond the scope of this course; however, further guidance may be found in *PPC's Guide to Preparing Financial Statements*, which may be ordered by calling (800) 431-9025 or at **tax.thomsonreuters.com**.

Definition of Comprehensive Income

Comprehensive income includes both net income and other comprehensive income (i.e., certain revenues, expenses, gains, and losses that are reported as separate components of stockholder's equity rather than in net income). Under FASB ASC 220-10-45-10A, other comprehensive income includes (not all inclusive):

- unrealized gains and losses on debt and equity securities classified as available-for-sale.
- amounts recognized in other comprehensive income for debt securities classified as available-for-sale and held-to-maturity related to an other-than-temporary impairment.
- gains or losses related to pension or other postretirement benefits.
- prior service costs or credits related to pension or other postretirement benefits.
- transition assets or obligations related to pension or other postretirement benefits.
- foreign currency translation adjustments and gains and losses from certain foreign currency transactions.
- the effective portion of the gain or loss on derivative instruments designated as cash flow hedging instruments (including qualifying foreign currency cash flow hedges).

A company that does not have any of these components of comprehensive income in any period presented is not required to report comprehensive income. In most situations, unless a client has debt or equity securities accounted for under FASB ASC 320-10, accountants will find that their small business clients do not have any of these comprehensive income components and that these reporting requirements are therefore not applicable.

Presentation of Comprehensive Income

FASB ASC 220-10-45 requires total comprehensive income, the components of net income, and the components of other comprehensive income to be presented either in (a) a single continuous statement of comprehensive income or (b) two separate but consecutive statements.

Reclassification Adjustments. Reclassification adjustments to other comprehensive income may be necessary to avoid double counting items that are included in net income in the current period that were previously reported as other comprehensive income in prior periods. An example would be realized gains or losses on available-for-sale marketable securities reported in the current year's net income that were reported as unrealized holding gains or losses in other comprehensive income in prior periods. Reclassification adjustments should be calculated for each component of other comprehensive income. Reclassification adjustments out of accumulated other comprehensive income must be presented by component and may either be presented on the face of the financial statement where the components of other comprehensive income are presented or disclosed in the notes to the financial statements. Additional reporting of the effect reclassification adjustments have on specific line items in the income statement is required.

Reporting Tax Effects Related to Other Comprehensive Income. Components of comprehensive income may be presented net of related tax effects, or may be presented before related tax effects with one amount displayed for the aggregate income tax expense or benefit related to the total other comprehensive income. However, the amount of income tax expense or benefit allocated to each component of comprehensive income (and related reclassification adjustments) should be disclosed on the face of the financial statements or in the notes to the financial statements.

Single-statement Format. In a single-statement format (that is, a combined statement of income and comprehensive income), comprehensive income is reported in two primary sections corresponding to the two components of comprehensive income: net income and other comprehensive income. Additionally, FASB ASC 220-10-45-1A requires the following elements to be included in a statement of income and comprehensive income presented in the single-statement format, if applicable:

a. the components that make up net income,

b. a total for net income,

c. the components of other comprehensive income,

d. a total for other comprehensive income, and

e. a total for comprehensive income.

The following illustration shows the placement of the primary captions of comprehensive income presented using the single-statement format. The illustration assumes the reporting entity is presenting consolidated financial statements.

ABC COMPANY, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENT OF INCOME AND
COMPREHENSIVE INCOME
YEAR ENDED DECEMBER 31, 20X1

REVENUES		$ 8,924,000
COSTS AND EXPENSES		
Cost of goods sold	$ 3,185,000	
Selling, general, and administrative expenses	2,283,000	5,468,000
OTHER INCOME		
Gain on sale of securities (includes $50,000 reclassification from accumulated other comprehensive income for previously unrealized gains on securities)		54,500
INCOME BEFORE INCOME TAXES		3,510,500
INCOME TAXES (includes $20,000 for reclassification adjustment from unrealized gains on securities)		1,404,200
CONSOLIDATED NET INCOME		2,106,300
LESS: NET INCOME ATTRIBUTABLE TO THE NONCONTROLLING INTEREST		421,260
NET INCOME ATTRIBUTABLE TO ABC COMPANY SHAREHOLDERS		1,685,040
OTHER COMPREHENSIVE INCOME, NET OF TAX		
Foreign currency translation adjustments		60,000
Unrealized gains on securities		
Unrealized holding gains arising during the period	150,000	
Less: reclassification adjustment for gains included in net income	(30,000)	120,000

Defined benefit pension plans		
Prior service cost arising during the period	(12,000)	
Net loss arising during the period	(9,000)	
Less: amortization of prior service cost included in net periodic pension cost	6,000	(15,000)
OTHER COMPREHENSIVE INCOME		165,000
TOTAL COMPREHENSIVE INCOME		2,271,300
LESS: COMPREHENSIVE INCOME ATTRIBUTABLE TO THE NONCONTROLLING INTEREST		454,260
COMPREHENSIVE INCOME ATTRIBUTABLE TO ABC COMPANY SHAREHOLDERS		$ 1,817,040

The previous illustration presents the gross amounts of each component of accumulated other comprehensive income as well as the effects of reclassifications on the specific line items in the income statement. The illustration also presents the components of other comprehensive income net of tax. Alternatively, they could be presented before tax with one amount shown for aggregate income tax expense, as shown in the following illustration.

OTHER COMPREHENSIVE INCOME		
Foreign currency translation adjustments		100,000
Unrealized gains on securities		
Unrealized holding gains arising during the period	$ 250,000	
Less: reclassification adjustment for gains included in net income	(50,000)	200,000
Defined benefit pension plans		
Prior service cost arising during the period	(20,000)	
Net loss arising during the period	(15,000)	
Less: amortization of prior service cost included in net periodic pension cost	10,000	(25,000)
		275,000
Income tax expense related to items of other comprehensive income		110,000
OTHER COMPREHENSIVE INCOME		165,000

In either presentation, the tax effects applicable to each component of other comprehensive income should be disclosed parenthetically on the face of, or in the notes to, the financial statements.

Two-statement Format. As discussed above, a reporting entity has the option of reporting comprehensive income in two separate but consecutive financial statements. When that reporting format is elected, the statement of comprehensive income should be presented immediately following the statement of income. The two statements are required to be presented consecutively.

According to FASB ASC 220-10-45-1B, when a reporting entity uses the two-statement approach, the statement of income (sometimes referred to as the "statement of net income") should include the components of net income and a total for net income. The statement of comprehensive income should begin with net income and present the following items:

a. the components of other comprehensive income,

b. a total for other comprehensive income, and

c. a total for comprehensive income.

The following illustration presents a separate statement of comprehensive income that begins with a total for net income. The illustration assumes the reporting entity is presenting consolidated financial statements and that a separate statement of income was included immediately preceding the statement of comprehensive income.

ABC COMPANY, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
YEAR ENDED DECEMBER 31, 20X1

NET INCOME		$ 2,106,300
OTHER COMPREHENSIVE INCOME, NET OF TAX		
Foreign currency translation adjustments		60,000
Unrealized gains on securities		
Unrealized holding gains arising during the period	$ 150,000	
Less: reclassification adjustment for gains included in net income	(30,000)	120,000
Defined benefit pension plans		
Prior service cost arising during the period	(12,000)	
Net loss arising during the period	(9,000)	
Less: amortization of prior service cost included in net periodic pension cost	6,000	(15,000)
OTHER COMPREHENSIVE INCOME		165,000
COMPREHENSIVE INCOME		2,271,300
COMPREHENSIVE INCOME ATTRIBUTABLE TO THE NONCONTROLLING INTEREST		(70,000)
COMPREHENSIVE INCOME ATTRIBUTABLE TO ABC COMPANY SHAREHOLDERS		$ 2,201,300

The previous illustration presents the components of other comprehensive income net of tax. Alternatively, they could be displayed before tax with one amount shown for aggregate income tax expense. In either case, the tax effects applicable to each component of other comprehensive income should be disclosed parenthetically on the face of, or in the notes to, the financial statements. The illustrated statement also presents the gross amounts of unrealized holding gains and reclassification adjustment.

SELF-STUDY QUIZ

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

1. Baker's Dozen, a calendar-year C corporation, presents a single set of basic financial statements. The statements were audited. Which of the following should be included on the title page?

   a. BAKER'S DOZEN, C CORPORATION.

   b. BALANCE SHEET AND OTHER FINANCIAL STATEMENTS.

   c. Years Ended December 31, 2018 and 2017.

   d. (These statements have been audited.)

2. Which of the following statements best describes the presentation of basic GAAP financial statements?

   a. A balance sheet, a statement of cash flows, and financial statement notes should be included.

   b. Detailed schedules and specific statistical information should be included as supplementary information.

   c. They must be comparative financial statements unless there is a compelling reason why that is impracticable.

   d. Every page of the presentation should include a note as to how much responsibility was taken by the practitioner.

3. "Statement of Operations" is an alternative title for what basic financial statement?

   a. Balance sheet.

   b. Statement of income.

   c. Statement of changes in stockholder's equity.

   d. Statement of cash flows.

SELF-STUDY ANSWERS

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

1. Baker's Dozen, a calendar-year C corporation, presents a single set of basic financial statements. The statements were audited. Which of the following should be included on the title page? **(Page 5)**

   a. BAKER'S DOZEN, C CORPORATION. [This answer is incorrect. The name of the company should be presented exactly as listed in the charter, partnership agreement, or other appropriate legal document. When the company is *not* a regular corporation, the type of legal entity should be disclosed. Since Baker's Dozen is a C corporation, it does not need to disclose the type of entity. Also, even if Baker's Dozen needed to disclose its legal entity, a best practice would be to do so parenthetically in the accountant's report, not on the title page unless it matches how the company's name is presented on the charter.]

   b. BALANCE SHEET AND OTHER FINANCIAL STATEMENTS. [This answer is incorrect. If the presentation includes more than one type of financial statement, the term *Financial Statements* is the most practical method of communicating to the reader what is included in the presentation. When only one type of statement is presented, it is more appropriate to use the exact title of the statement. Therefore, in this instance, Baker's Dozen should use FINANCIAL STATEMENTS on its title page.]

   c. Years Ended December 31, 2018 and 2017. [This answer is correct. When both a balance sheet and statement of income are presented, the period covered by the statement (or statements) of income should be shown on the title page. Appropriate examples include "Years Ended December 31, 2018 and 2017" and "Six Months Ended June 30, 2018." Therefore, if these are the correct dates for the basic financial statements, this presentation of the date on the title page would be correct.]

   d. (These statements have been audited.) [This answer is incorrect. Comparative statements may include one period that is audited and another period that is unaudited. The title page may indicate the level of service by adding "(Unaudited)" and "(Audited)" after the appropriate dates. Since this question asks about basic financial statements, not comparative financial statements, the title page does not need to specify whether the statements have been audited.]

2. Which of the following statements best describes the presentation of basic GAAP financial statements? **(Page 9)**

   a. A balance sheet, a statement of cash flows, and financial statement notes should be included. [This answer is correct. The basic financial statements included in a typical GAAP financial statement presentation are (1) balance sheet, (2) statement of income, (3) statement of comprehensive income, (4) statement of retained earnings or changes in stockholders' equity, and (5) statement of cash flows. The typical presentation also includes descriptions of accounting policies and notes to the financial statements. Therefore, everything listed above, in addition to several other items, would be included in the basic presentation.]

   b. Detailed schedules and specific statistical information should be included as supplementary information. [This answer is incorrect. The unaudited financial statements of a nonpublic entity often include detailed schedules, summaries, comparisons, or statistical information that are not part of the basic financial statements. This information can be included if it is useful to financial statement users, but it is not required for fair presentation in accordance with GAAP.]

   c. They must be comparative financial statements unless there is a compelling reason why that is impracticable. [This answer is incorrect. Although they are not required, FASB ASC 205-10-45-1 clearly states that comparative financial statements enhance the usefulness of statements and are therefore preferable. Therefore, while it would be a best practice to present comparative financial statements, it is not a mandatory requirement and the entity would not need special disclosure of why it did not do so.]

d. Every page of the presentation should include a note as to how much responsibility was taken by the practitioner. [This answer is incorrect. AR-C 70 allows the accountant to prepare financial statements without issuing an accountant's report. To avoid any inappropriate reliance on the accountant's work, AR-C 70.14 requires each page of the financial statements to include a statement indicating no assurance has been provided on the financial statements. However, this would not be required if the practitioner did preform the procedures to issue an accountant's report on the statements.]

3. "Statement of Operations" is an alternative title for what basic financial statement? **(Page 12)**

a. Balance sheet. [This answer is incorrect. In practice, the most widely used title for a balance sheet is "Balance Sheet." However, "Statement of Financial Position" also is acceptable. "Statement of Operations," however, would not be acceptable for the balance sheet.]

b. Statement of income. [This answer is correct. Alternative titles for presentation of an income statement include (1) Statement of Income, (2) Income Statement, (3) Statement of Earnings, and (4) Statement of Operations. The title "Statement of Operations" or "Statement of Income (Loss)" may be used when the company has incurred a loss during the reporting period. However, many practitioners continue to use the title "Statement of Income" when a loss occurs.]

c. Statement of changes in stockholder's equity. [This answer is incorrect. Changes, if any, in stockholders' equity must be disclosed. Practitioners can do this in a note to the financial statements or they can present a separate statement titled "Statement of Changes in Stockholders' Equity." However, this consideration is related to the statement of retained earnings, so "Statement of Operations" would not be an acceptable title.]

d. Statement of cash flows. [This answer is incorrect. There is no GAAP requirement for the title of the statement of cash flows. However, FASB ASC 230, *Statement of Cash Flows,* generally refers to the statement as the "Statement of Cash Flows." However, no matter what title it uses, the statement of cash flows is a different basic financial statement than the one to which a "Statement of Operations" title would apply.]

THE STATEMENTS OF RETAINED EARNINGS OR CHANGES IN STOCKHOLDERS' EQUITY

General

In most situations, unless the client has debt or equity securities accounted for under FASB ASC 320-10 and 942-320-50, the only stockholders' equity account to change during the period covered by the statements of a nonissuer will be the retained earnings account. Generally, a combined statement of income and retained earnings is the best way to disclose changes in retained earnings. Alternatively, the change in retained earnings may be disclosed adequately on the face of the balance sheet. Many computer-prepared financial statements, for example, present retained earnings on the balance sheet in two segments—Prior or Beginning Retained Earnings and Current Year-to-date Earnings. This adequately discloses the change in retained earnings especially when earnings represent the only change. In other circumstances, the type of changes or number of changes will sometimes necessitate a separate statement of retained earnings. Changes, if any, in other stockholder equity accounts must also be disclosed. Disclosure of these changes may be made in a note to the financial statements or may be presented in a separate Statement of Changes in Stockholders' Equity. Illustrations presenting changes in stockholder equity accounts are presented in the following paragraphs.

Compiled financial statements that omit substantially all disclosures may not include a statement of changes in retained earnings and may not disclose the changes in retained earnings on the face of the financial statements. Some accountants have questioned whether this lack of information should be considered a departure from GAAP. According to FASB ASC 505-10-50-2, the changes in equity accounts is considered a required disclosure, but not a required statement. Therefore, such information is not required to be disclosed in compiled financial statements that omit substantially all disclosures. However, when disclosures are omitted from compiled financial statements, it is a best practice to show the change in retained earnings either on the income statement or face of the balance sheet, as discussed in the preceding paragraphs.

Combined Statement of Income and Retained Earnings

A combined statement of income and retained earnings could be presented as follows:

CONTINENTAL CORPORATION
STATEMENTS OF INCOME AND RETAINED EARNINGS
Years Ended December 31, 20X2 and 20X1

	20X2	20X1
NET SALES	$ 35,337,000	$ 32,785,000
COST AND EXPENSES		
Cost of products sold	21,780,000	20,530,000
Selling and administration	7,032,000	6,525,000
Interest on long-term debt	891,000	910,000
Miscellaneous	244,000	215,000
	29,947,000	28,180,000
INCOME BEFORE INCOME TAXES	5,390,000	4,605,000
INCOME TAXES		
Current	2,000,000	2,000,000
Deferred	600,000	290,000
	2,600,000	2,290,000
NET INCOME	2,790,000	2,315,000
RETAINED EARNINGS AT BEGINNING OF YEAR	12,172,000	10,783,000
Cash dividends on common stock (20X2—$.75 per share; 20X1—$.50 per share)	(1,395,000)	(926,000)
RETAINED EARNINGS AT END OF YEAR	$ 13,567,000	$ 12,172,000

See accompanying notes.

Restatement of Retained Earnings

An illustration of the restatement of retained earnings as it might appear in a statement of income and retained earnings follows. (When there are numerous transactions in the retained earnings account, a separate statement of retained earnings may be easier to understand.)

NET INCOME	$ 2,790,000
RETAINED EARNINGS AT BEGINNING OF YEAR	
As previously reported	12,172,000
Adjustments—Note B	(742,000)
As restated	11,430,000
Cash dividends on common stock ($.75 per share)	(1,395,000)
RETAINED EARNINGS AT END OF YEAR	$ 12,825,000

See accompanying notes.

Separate Statement of Retained Earnings

A separate statement of retained earnings might appear as follows:

THE FEDERAL COMPANY
STATEMENTS OF RETAINED EARNINGS
Years Ended December 31, 20X2 and 20X1

	20X2	20X1
RETAINED EARNINGS AT BEGINNING OF YEAR	$ 1,586,000	$ 1,380,000
Net income	875,000	511,000
Dividends		
In cash		
On preferred stock ($3.50 a share)	(105,000)	(105,000)
On common stock (20X2—$1.25 a share; 20X1—$1.00 a share)	(250,000)	(200,000)
In stock		
Fair value of 10,000 shares of common stock issued as stock dividend—5%	(374,000)	—
RETAINED EARNINGS AT END OF YEAR	$ 1,732,000	$ 1,586,000

See accompanying notes.

Statement of Changes in Stockholders' Equity—Comparative Statements Presented

Following is a comparative statement of changes in stockholders' equity:

THE EASTERN COMPANY
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Years Ended December 31, 20X2 and 20X1

	20X2	20X1
COMMON STOCK		
Balance at beginning of year	$ 13,000,000	$ 12,591,250
Par value of shares issued		
Sold under stock option plan (20X2—10,000 shares; 20X1—3,750 shares)	50,000	18,750
Stock dividend—3% (20X2—78,300 shares; 20X1—78,000 shares)	391,500	390,000
BALANCE AT END OF YEAR	$ 13,441,500	$ 13,000,000
ADDITIONAL PAID-IN CAPITAL		
Balance at beginning of year	$ 580,000	$ 289,650
Proceeds or market value in excess of par value of shares of common stock issued:		
Sold under stock option plan	30,000	10,350
Stock dividend	783,000	280,000
BALANCE AT END OF YEAR	$ 1,393,000	$ 580,000
RETAINED EARNINGS		
Balance at beginning of year	$ 6,560,000	$ 6,152,000
Net income for the year	3,065,000	2,118,000
Dividends		
Cash (20X2—$.50 a share; 20X1—$.40 a share)	(1,335,000)	(1,040,000)
Market value of shares of common stock issued as a stock dividend—3%	(1,174,500)	(670,000)
BALANCE AT END OF YEAR	$ 7,115,500	$ 6,560,000
COMMON STOCK IN TREASURY		
Balance at beginning of year	$ —	$ —
Purchase of 30,000 shares for treasury	(450,000)	—
BALANCE AT END OF YEAR	$ (450,000)	$ -0-
TOTAL STOCKHOLDERS' EQUITY	$ 21,500,000	$ 20,140,000

See accompanying notes.

Statement of Changes in Stockholders' Equity—Single Year Statement

Following is a separate statement of changes in stockholders' equity for a single year:

THE COLUMBIA COMPANY
STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
Year Ended December 31, 20X2

	(Dollars in Thousands)				
	Common Stock	Additional Paid-in Capital	Retained Earnings	Common Stock in Treasury	Total
BALANCE AT BEGINNING OF YEAR	$ 13,000	$ 580	$ 6,560	$ —	$ 20,140
Stock issued					
Sale of 400,000 shares of common stock	2,000	4,000	—	—	6,000
Sale of 10,000 shares of common stock under stock option plan	50	60	—	—	110
Net income	—	—	3,065	—	3,065
Dividends					
Cash—$.50 a share	—	—	(1,535)	—	(1,535)
In common stock—3% (90,000 shares)	450	900	(1,350)	—	—
Treasury stock					
Cost of 30,000 shares of common stock	—	—	—	(450)	(450)
BALANCE AT END OF YEAR	$ 15,500	$ 5,540	$ 6,740	$ (450)	$ 27,330

See accompanying notes.

Negative Equity

If liabilities exceed assets, a negative equity balance will be reported. It is best not to use the term *equity* in those situations. A best practice would be to use the following captions instead:

- Negative equity shown in all periods—"Deficiency in assets" or "Stockholders' deficit."
- Negative equity shown in one period and positive equity shown in another period—"Stockholders' equity (deficiency in assets)" or "Stockholders' equity (deficit)."

THE STATEMENT OF CASH FLOWS

This section discusses the requirements of FASB ASC 230. It discusses presenting specific types of transactions in cash flow statements and preparing a separate schedule of noncash transactions. It also illustrates alternative formats for presenting cash flow statements.

FASB ASC 230-10-15-3 requires presentation of a statement of cash flows as part of a full set of financial statements. If comparative statements are presented, a cash flow statement should be presented for each period for which a statement of income is presented. These requirements apply to all profit-oriented entities and nonprofit organizations and apply whether or not the assets and liabilities are classified as current or noncurrent. A statement of cash flows is not required when cash or tax basis financial statements are presented. Also, this statement is not required for personal financial statements.

How Cash Is Defined

A statement of cash flows shows the change in cash and cash equivalents during the period. Cash and cash equivalents are defined as shown in Exhibit 1-1.

Exhibit 1-1

GAAP Definitions

CASH

Definition (FASB ASC 230-10-20)

. . . cash includes not only currency on hand but demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty . . . .

Examples—Certificates of deposit,[a] money market accounts, and repurchase agreements that have the characteristics described above.

CASH EQUIVALENTS

Definition (FASB ASC 230-10-20)

. . . short-term, highly liquid investments that (a) are readily convertible to known amounts of cash and (b) are so near to their maturity that they present insignificant risk of changes in value because of changes in interest rates.

Examples—Treasury bills, commercial paper, money market accounts that are not classified as cash, and other short-term investments with original maturities of three months or less.[b] (Note that equity securities never meet the definition of cash equivalents.)

Notes:

[a] If penalties associated with certificates of deposit or money market accounts are material or if stated terms effectively restrict withdrawal of funds, the funds should be classified as cash equivalents or investments, depending on their maturities.

[b] Only those investments that mature three months or less from the date they were purchased qualify as cash equivalents. For example, a three-month Treasury bill and a three-year Treasury note purchased three months from maturity both qualify as cash equivalents. A Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months, however.

* * *

This course uses the term *cash* to include *cash equivalents*.

Basic Elements

A statement of cash flows has five basic elements:

a. Cash flows from operating activities.

b. Cash flows from investing activities.

c. Cash flows from financing activities.

d. Net change in cash during the period.

e. Supplemental disclosure of noncash investing and financing activities.

Accordingly, all cash receipts and payments should be classified as operating, investing, or financing activities, and noncash transactions involving investing and financing activities, such as acquiring assets by assuming liabilities, should be disclosed separately rather than within the body of the statement.

Types of Cash Flows. Exhibit 1-2 shows how a typical company's transactions would be classified into operating, investing, and financing activities according to the GAAP criteria.

Exhibit 1-2

Types of Cash Flows

STATEMENT OF CASH FLOWS OPERATING	INVESTING	FINANCING	NONCASH INVESTING AND FINANCING TRANSACTIONS
CASH RECEIPTS FROM: • Sale of goods and services • Short-term and long-term notes receivable from customers arising from sales of goods or services • Interest and dividends • Other cash receipts not arising from investing or financing activities, such as amounts received to settle lawsuits or refunds from suppliers	**CASH RECEIPTS FROM:** • Sale of property and equipment • Sale of certain securities • Collections on loans • Insurance proceeds relating to transactions classified as investing	**CASH RECEIPTS FROM:** • Short-term borrowings • Long-term borrowings • Issuance of stock	• Acquiring nonoperating assets (e.g., property and equipment or a subsidiary) by assuming liabilities or exchanging assets • Issuing stock in exchange for subscriptions receivable or other noncash consideration • Converting debt to equity or one class of stock to another (e.g., common to preferred) • Stock dividends or distributions of property as dividends • Converting notes receivable to investments
CASH PAYMENTS FOR: • Inventory • Short-term and long-term notes payable to suppliers for materials or goods • Wages • Other operating expenses • General and administrative expenses • Interest (excluding amounts capitalized) • Settlement of an asset retirement obligation • Taxes • Other cash payments not related to investing or financing activities, such as cash contributions and cash refunds to customers	**CASH PAYMENTS FOR:** • Property and equipment (including capitalized interest) • Certain securities • Loans to others	**CASH PAYMENTS FOR:** • Dividends • Repayment of amounts borrowed (e.g., short-term debt, long-term debt, and capital lease obligations) • Treasury stock	

Gross and Net Cash Flows

Cash flows from investing and financing activities are generally required to be reported gross rather than net. For example, cash flow statements would show the following amounts:

a. Investing Activities

   (1) Proceeds from sales of assets and cash payments for capital expenditures rather than the net change in property and equipment.

   (2) Proceeds from sales and maturities of securities and purchases of, rather than the net change in, those investments.

   (3) Loans made and collections on loans rather than the net change in notes and loans receivable.

b. Financing Activities

   (1) Proceeds from long-term borrowings and repayments of long-term obligations (including capital lease obligations) rather than the net change in long-term debt.

   (2) Proceeds from short-term debt and payments to settle short-term debt rather than the net change in short-term debt when the debt term exceeds three months.

While the general rule calls for reporting gross cash flows, reporting net cash flows from the following activities is permitted:

a. Cash receipts and payments from purchasing and selling cash equivalents.

b. Cash receipts and payments related to investments (other than cash equivalents), loans receivable, and debt when the original maturity of the asset or liability is three months or less.

c. Cash receipts and payments from agency transactions (that is, transactions for which the company is holding or disbursing cash on behalf of its customers).

d. For certain financial institutions, cash receipts and payments related to—

   (1) Deposits placed with other financial institutions

   (2) Customer time deposits

   (3) Loans made to customers

Presentation Considerations

Cash flow statements should report the net change in cash during the period presented and reconcile the net change in cash to cash at the beginning of the period to obtain cash at the end of the period. The ending balance of cash and cash equivalents on the statement of cash flows should agree with the balance sheet. Therefore, it may be necessary to reclassify or subtotal cash captions on the balance sheet to agree with the statement of cash flows.

Title. GAAP does not specify a title for statements of cash flows. However, FASB ASC 230, *Statement of Cash Flows*, generally refers to the statement as the "Statement of Cash Flows." In addition, the illustrative examples use the title "Statement of Cash Flows." As such, it would be a good idea to use this title.

Order of Presentation. The order for presenting operating, investing, and financing activities in statements of cash flows is not addressed in GAAP; however, it is likely that most companies will report cash flows from operations first. The format used in the illustrations included in FASB ASC 230-10-55 shows investing activities following operations and to present financing activities last. It is acceptable, however, to present financing activities before investing activities.

Captions. Because cash flow statements are classified according to cash flows from operating, investing, and financing activities, captions are used to identify each section. Some typical examples are as follows:

a. Cash Flows from Operating Activities, Cash Flows from Investing Activities, Cash Flows from Financing Activities

b. Cash Provided (Used) by Operations, Cash Provided (Used) by Investments, Cash Provided (Used) by Financing

c. Operations, Investments (or Investment Activities), Financing (or Financing Activities)

This course uses the captions "Cash Flows from Operating Activities," "Cash Flows from Investing Activities," and "Cash Flows from Financing Activities" because those captions are used by many companies and in the illustrative cash flow statements in FASB ASC 230-10-55. In addition, a captioned subtotal shows the net cash flow provided or used by each classification. This course also uses "Net Cash Provided (Used) by. . . ." Finally, this course uses the caption "Net Increase (Decrease) in Cash" to identify the change in cash during the period.

Cash Flows from Operating Activities

What Is Included? FASB ASC 230-10-20 defines cash flows from operating activities by exception; operating activities include all transactions and events that are not investing or financing activities. Generally, however, operating activities meet the following three criteria:

a. The amounts represent the *cash effects* of transactions or events.

b. The amounts result from a company's normal operations for delivering or producing goods for sale and providing services.

c. The amounts are derived from activities that enter into the determination of net income.

Thus, cash flows from operating activities include cash received from sales of goods or services, and cash used in generating the goods or services such as for inventory, personnel, and administrative and other operating costs. Collections of short- or long-term notes receivable from customers arising from sales and payments of short-term or long-term notes payable to suppliers for materials for manufacture or goods for resale would be considered operating activities. In addition, interest and dividend income, interest expense, and cash payments to settle an asset retirement obligation are considered to be operating activities even though they are not precisely consistent with the preceding criteria. (Exhibit 1-2 lists some typical examples of cash flows from operating activities.)

What Is Excluded? Cash flows from operating activities exclude (a) amounts that are not derived from cash receipts and payments, e.g., accruals, deferrals, and allocations such as depreciation, and (b) amounts that are considered to be derived from investing or financing activities rather than from operations, e.g., cash receipts and payments related to property and equipment, or investments and dividends paid.

Basic Presentation. Cash flows from operations may be presented in either of two basic formats: the direct method or the indirect method. Although GAAP encourages use of the direct method, many preparers use the indirect method. The following paragraphs describe each method and explain their advantages and disadvantages.

Direct Method. The direct method begins with cash receipts and deducts cash payments for operating costs and expenses, individually listing the cash effects of each major type of revenue and expense. At a minimum, FASB ASC 230-10-45-25 indicates the following categories of operating cash receipts and payments are required to be presented:

a. Cash collected from customers, including lessees and licensees.

b. Interest and dividends received.

c. Other operating cash receipts, if any.

d. Cash paid to employees and other suppliers of goods and services, including suppliers of insurance and advertising.

e. Interest paid.

f. Income taxes paid.

g. Other operating cash payments, if any.

Because the direct method explicitly shows only cash receipts and payments, no adjustments are necessary for noncash expenses such as depreciation or deferred income taxes. However, if the direct method is used, a separate schedule reconciling net income to cash flows from operations is required. This is the same reconciliation that is shown in a statement prepared using the indirect method. This reconciliation should separately show all major classes of operating items, including, at a minimum, changes in receivables and payables related to operating activity and changes in inventory. An example of the direct method is as follows:

CASH FLOWS FROM OPERATING ACTIVITIES	
Cash collected from customers	$ 348,000
Interest and dividends received	1,950
Cash paid to employees and suppliers	(284,700)
Interest paid	(5,600)
Income taxes paid	(11,000)
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 48,650

Proponents of the direct method believe that this approach is preferable because it shows the actual sources and uses of cash from operating activities. In addition, some accountants believe the use of the direct method makes the statement of cash flows easier to understand because there is no need to adjust for noncash items such as depreciation. On the other hand, the direct method is not used by many companies, and it may take more time to prepare a statement using the direct method than using the indirect method. Nevertheless, some companies may find cash flow statements that use the direct method easier to understand and, in those cases, using the direct method would be a best practice.

Indirect Method. The indirect method starts with net income and adjusts for (a) noncash items such as depreciation and deferred income taxes and (b) accruals. An example of the indirect method is as follows:

CASH FLOWS FROM OPERATING ACTIVITIES	
Net income	$ 223,000
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation	29,400
Gain on sale of equipment	(6,700)
Decrease in receivables	27,500
Increase in inventory	(7,700)
Increase in payables	32,600
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 298,100

Items that reconcile net income to net cash flows from operating activities are allowed to be presented in the statement of cash flows itself, as illustrated in the preceding paragraph, or in a separate schedule. If the reconciling items were presented in a separate schedule, the cash flow statement would show a single line item for cash flows from operations such as the following:

Net Cash Flows from Operating Activities	$ 298,100

In that case, a separate schedule would present a reconciliation of net income to net operating cash flows such as:

RECONCILIATION OF NET INCOME TO NET CASH FLOWS FROM OPERATING ACTIVITIES	
Net income	$ 223,000
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation	29,400
Gain on sale of equipment	(6,700)
Decrease in receivables	27,500
Increase in inventory	(7,700)
Increase in payables	32,600
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 298,100

Whether a reconciliation of net income to net cash flows from operations is shown within the cash flow statement itself or separately disclosed in the notes to the financial statements, all noncash items should be clearly distinguished. Additionally, if the statement of cash flows is presented using the indirect method, the amounts of interest (net of capitalized interest) and taxes paid should be disclosed.

Which Method Is Better? As mentioned above, many users of financial statements will find the direct method easier to understand and more informative because it shows sources and uses of cash from operating activities. (This method is also encouraged in FASB ASC 230-10-45-25.) Others may find the indirect method more informative because it allows presentation of the reconciliation of net income to net cash flow in the body of the cash flow statement rather than in a separate schedule as under the direct method. It seems likely that most companies will find the indirect method easier and less expensive to implement. However, the information presented under the indirect method must be in sufficient detail to allow the reader to roughly approximate operating cash receipts and payments.

Changes in Operating Current Assets and Liabilities. When cash flows from operating activities are presented using the indirect method, net income should be adjusted for changes during the period in operating current assets and liabilities such as trade accounts receivable, accrued interest or dividends receivable, inventory, prepaid expenses, trade accounts payable, and accrued interest payable and other accrued liabilities. The changes in each account may be shown separately, though netting of certain accounts is permitted.

Noncash entries to current operating assets and liabilities generally should be presented as separate adjustments to net income in arriving at cash flows from operations. Common examples of noncash transactions affecting current operating assets and liabilities include recording a provision for bad debts and providing a reserve for inventory obsolescence. To illustrate, assume that a company's activities relating to trade accounts receivable are summarized as follows:

	Accounts Receivable	**Allowance for Doubtful Accounts**
Balance 1/1/X1	$ 50,000	$ 10,000
Sales	300,000	—
Cash collected	(250,000)	—
Bad debt provision	—	25,000
Write-offs	(20,000)	(20,000)
Balance 12/31/X1	$ 80,000	$ 15,000

The operations section of the cash flow statement would be presented as follows:

CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$	50,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for losses on accounts receivable		25,000
Increase in accounts receivable		(50,000)
NET CASH PROVIDED BY OPERATING ACTIVITIES	$	25,000

If noncash entries are not material, however, presenting only the net change in current assets and liabilities seems like an apporpriate option.

Cash Flows from Investing Activities

Investing activities include the following:

a. Lending money and collecting on loans.

b. Acquiring and selling or disposing of securities.

c. Acquiring and selling or disposing of productive assets that are expected to generate revenue over a long period of time.

Exhibit 1-2 lists some typical examples of cash flows provided by and used in investing activities.

Presentation Considerations. FASB ASC 230-10-45-7 through 45-9 sets a general rule that cash receipts and payments should be reported on a gross rather than a net basis. However, cash flows related to loans and short-term investments with original maturities of three months or less and credit card receivables may be reported net rather than gross. All other cash receipts and payments from investing activities should be reported on a gross basis. (Note: As previously discussed, banks, savings institutions, and credit unions are allowed to net certain cash receipts and payments. This netting is unique to financial institutions and not discussed further in this course.)

Certain investing activities, such as acquiring assets by assuming liabilities or exchanging assets, are noncash transactions that do not involve cash receipts or payments. Nevertheless, investing activities that do not involve cash are required to be reported separately so that information is provided on all investing activities. A discussion of reporting noncash investing activities appears later in this lesson.

Cash Flows from Financing Activities

FASB ASC 230-10-20 states that financing activities include the following:

- Obtaining resources from owners and providing them with a return on, and a return of, their investment.
- Borrowing money and repaying the amounts borrowed or otherwise settling the obligation.
- Obtaining and paying for other resources from creditors on long-term credit.
- Receiving resources from donors with use stipulated for long-term purposes.

Exhibit 1-2 lists some typical examples of cash flows provided by financing activities. The following paragraphs discuss how to present cash flows from financing activities in statements of cash flows.

Presentation Considerations. Cash receipts and payments are generally required to be reported on a gross rather than a net basis. However, cash flows related to loans with original maturities of three months or less may be reported net rather than gross. All other financing activities should be reported gross. (Note: As previously discussed, banks, savings institutions, and credit unions are allowed to net certain cash receipts and payments. This netting is unique to financial institutions and not discussed further in this course)

Certain financing activities, such as issuing stock in exchange for property and equipment, do not involve cash receipts or payments. (Exhibit 1-2 lists other typical examples of noncash financing activities.) Financing activities that do not involve cash are required to be reported in a separate schedule so that information is provided on all financing activities. A discussion on reporting noncash financing activities begins below.

Noncash Investing and Financing Activities

Investing and financing activities that do not involve cash receipts and payments during the period are required to be excluded from the cash flow statement and reported in a separate schedule. The appendix to FASB ASC 230-10-55-11 includes the following illustrative schedule:

> The Company purchased all of the capital stock of Company S for $950. In connection with the acquisition, liabilities were assumed as follows:
>
> | | | |
> |---|---|---|
> | Fair value of assets acquired | $ | 1,580 |
> | Cash paid for the capital stock | | (950) |
> | Liabilities assumed | $ | 630 |
>
> A capital lease obligation of $850 was incurred when the Company entered into a lease for new equipment.
>
> Additional common stock was issued upon the conversion of $500 of long-term debt.

Because the schedule of noncash investing and financing transactions is not self-balancing, it is possible to inadvertently omit a noncash transaction from the schedule. Thus, all investing and financing transactions should be carefully reviewed to ensure that all noncash transactions are included.

Presentation Considerations. Noncash investing and financing activities should be disclosed either in narrative form or in a schedule. The disclosure may be made on the same page as the statement of cash flows or elsewhere in the financial statements, e.g., in the notes. A good option is to present the schedule at the bottom of the cash flow statement. An example is as follows:

CASH FLOWS FROM OPERATING ACTIVITIES	
Net income	$ 66,200
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation	7,200
Increase in receivables	(10,000)
Decrease in inventory	2,000
Decrease in payables	(4,400)
NET CASH PROVIDED BY OPERATING ACTIVITIES	61,000
CASH FLOWS USED BY INVESTING ACTIVITIES	
Purchase of equipment	(30,000)
CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds of long-term borrowings	25,000
Repayment of long-term borrowings	(5,000)
NET CASH PROVIDED BY FINANCING ACTIVITIES	20,000
NET INCREASE IN CASH	51,000
CASH AT BEGINNING OF YEAR	75,000
CASH AT END OF YEAR	$ 126,000
SUPPLEMENTAL DISCLOSURES	
Noncash Investing and Financing Transactions:	
Capital lease obligation incurred for use of equipment	$ 15,600

THE SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

When Is It Required?

A summary of significant accounting policies is required by GAAP when financial statements that purport to present financial position (Balance Sheet), results of operations (Statement of Income), or cash flows (Statement of Cash Flows) are issued. When only one of these statements is issued, a summary of accounting policies pertinent to that statement is required. The disclosure of significant accounting policies is required for financial statements of not-for-profit entities as well as for profit-oriented entities. A summary of significant accounting policies is not required in unaudited interim financial statements unless an accounting policy has been changed since the last annual financial statement. As a practical matter some firms issuing interim full disclosure financial statements find it easier to simply leave the summary of significant accounting policies in. (Note: Interim financial statements, nevertheless, must include other disclosures required by GAAP.

What Must Be Included?

General Requirements. FASB ASC 235-10 states that disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, results of operations, or cash flows. In general, the disclosure should encompass important judgments as to appropriateness of principles related to recognition of revenue and allocation of asset costs to current and future periods. It should describe accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives.

b. Industry peculiarities.

c. Unusual or innovative applications of GAAP.

Specifically Required Accounting Policy Disclosures. Several authoritative pronouncements specifically require disclosure of an accounting policy. Some disclosures that are common for nonissuers are as follows:

- *Inventories*—the basis for stating inventories and the method of determining cost (FASB ASC 210-10-50-1).

- *Depreciation*—a general description of the methods used in computing depreciation for major classes of depreciable assets (FASB ASC 360-10-50-1).

- *Cash Equivalents*—the policy used to determine which short-term investments are treated as cash equivalents in the statement of cash flows (FASB ASC 230-10-50-1).

- *Marketable Securities*—the basis on which the cost of a security sold or the amount reclassified out of accumulated other comprehensive income into earnings was determined (FASB ASC 320-10-50-9) and the policy for requiring collateral or other security for repurchase agreements or securities lending transactions (FASB ASC 860-30-50-1A).

- *Notes Receivable or Loans*—the policy for accounting for loan and trade receivables including determination of allowances, charge offs, recognizing interest income, treatment of related fees, and how cash receipts are recorded (FASB ASC 310-10-50-2, 50-4A, and 50-15).

- *Advertising*—the policy used for reporting advertising (i.e., whether costs are expensed as incurred or when the advertising first takes place) (FASB ASC 340-20-50-1).

- *Sales and Similar Taxes*—the policy regarding the presentation of sales and similar taxes (e.g., use, value added, and certain excise taxes), that is, whether such taxes are presented on a gross or net basis (FASB ASC 605-45-50-3).

- *Shipping and Handling Costs*—the policy for classifying shipping and handling costs. For example, whether such costs are included in cost of sales (FASB ASC 605-45-50-2).

- *Interest and Penalties*—the policy for classifying interest, as income taxes or interest expense, and penalties, as income taxes or another expense (FASB ASC 740-10-50-19).

In addition to these examples, FASB ASC 235-10-50-4 identifies the following examples of required accounting policy disclosures:

- Recognition of profit on long-term, construction-type contracts

- Basis of consolidation

- Revenue recognition for franchising and leasing operations.

- Amortization of intangibles.

Recommended Accounting Policy Disclosures

As mentioned above, GAAP requires disclosure of all significant accounting policies. In addition to disclosures required by specific pronouncements, it is a best practice to disclose the accounting methods prescribed by authoritative literature that are relatively complex, such as the following:

- *Investments in Debt and Equity Securities*—describe the accounting treatment of unrealized gains and losses for investments classified as trading securities, held-to-maturity securities, and available-for-sale securities.

- *Deferred Income Taxes*—briefly describe how current and deferred taxes are calculated.

- *Investments at Equity*—disclose the lag if the investee's year end differs from the investor's year end. FASB ASC 323-10-35-6 recognizes that investees may not have the same year end as the investor and states that "a lag in reporting should be consistent from period to period." It is a best practice for the lag not to exceed three months, which is consistent with the guidance given in FASB ASC 810-10-45-12 for consolidations.

- *Derivatives*—describe the accounting treatment of gains and losses related to fair value, cash flow, or foreign currency hedges.

Several recently-issued ASUs offer nonpublic entities optional, simplified accounting alternatives. While not specifically listed in the disclosure requirements of the ASU, it is a best practice for a nonpublic entity to disclose its accounting policy on these topics, even when not opting to adopt the accounting alternative. Per FASB ASC 235-10-50-3, an entity should disclose its accounting policies when there is a selection from existing acceptable alternatives. With the introduction of the accounting alternatives discussed in the following paragraphs, nonpublic entities now have acceptable alternatives and should, therefore, disclose the policy selected, if applicable. The accounting alternatives provided to nonpublic entities include:

- Goodwill amortization on a straight-line basis over a maximum of 10 years.

- Cash flow hedge accounting practical expedients for qualifying receive-variable, pay-fixed interest rate swaps.

- Exemption from the consolidation requirements of the variable interest entities guidance in FASB ASC 810-10 for certain leasing arrangements with entities under common control.

- Recognition of fewer intangible assets separate from goodwill in a business combination.

The following is an example of how an entity might disclose its accounting policy regarding variable interest entities involving certain leasing arrangements under common control:

> The Company has adopted the accounting alternative offered to private companies in FASB ASC 810-10 for certain leasing arrangements with entities under common control. In accordance with this alternative, the Company does not evaluate entities that meet the requirements in the variable interest entities subsections of FASB ASC 810-10. Instead, the Company discloses the leasing arrangement as required by the accounting alternative. See Note H.

The following is an illustration of a company's disclosure of its use of cash flow hedge practical expedients for certain interest rate swaps:

> The Company has adopted the accounting alternative offered to nonpublic entities in FASB ASC 815-20 for certain variable rate borrowing involving receive-variable, pay-fixed interest rate swaps. In accordance with this alternative, the Company assumes there is no hedge ineffectiveness and applies the simplified hedge accounting approach for all interest rate swaps meeting those criteria. In addition, the Company measures the swap using settlement value rather than fair value. See Note G.

The following is an illustration of an accounting policy disclosure on adoption of the accounting alternative for the subsequent measurement of goodwill:

> Beginning in 2014, the Company adopted the accounting alternative offered to nonpublic entities for the subsequent measurement of goodwill. In accordance with this alternative, the Company amortizes goodwill over 10 years on the straight-line basis and only evaluates goodwill for impairment at the entity level when a triggering event occurs.

The following is an example of how an entity might disclose its accounting policy regarding recognition of intangible assets separate from goodwill in a business combination:

> In 20X5, the Company adopted the private company accounting alternative for the recognition of intangible assets in a business combination provided in FASB ASC 805-20. Based on that alternative, the Company does not separately recognize and measure certain customer-related intangibles and noncompete agreements acquired in a business combination but rather subsumes them into goodwill. See Note H. Accordingly, the Company also adopted the related accounting alternative for the subsequent measurement of goodwill and amortizes goodwill over 10 years on the straight-line basis and only evaluates goodwill for impairment at the entity level when a triggering event occurs.
>
> Customer-related intangibles and noncompete agreements existing prior to January 1, 20X5, continue to be accounted for separately, in accordance with the requirements in FASB ASC 805-20, and have not been subsumed into goodwill.

Manner of Disclosure

Significant accounting policies can be presented on the face of the statements, as part of individual notes to the financial statements, or in a separate note titled "Summary of Significant Accounting Policies." FASB ASC 235-10-50-6 expresses a preference for a separate "Summary of Significant Accounting Policies" as the initial note. When this method is used, the summary should not duplicate details presented elsewhere in the notes. However, it is appropriate to make specific reference to other notes that present related details.

Other Disclosures

Although there is no requirement that management acknowledge its responsibility with respect to the financial statements, some companies follow the policy of including such an acknowledgment in the "Summary of Significant Accounting Policies."

To make their financial statements more meaningful, some companies include a brief description of their activities.

THE NOTES TO THE ENTITY'S FINANCIAL STATEMENTS

General

Notes are an integral part of financial statements. They should be used to present material disclosures required by GAAP that are not otherwise presented in the statements, i.e., on the face of the statements or in the "Summary of Significant Accounting Policies." (The "Summary of Significant Accounting Policies," which is often considered to be included in the general category of notes to financial statements, is discussed separately in the preceding section.) When comparative financial statements are issued, FASB ASC 205-10-45-4 requires disclosures for prior periods to be repeated if they continue to be of significance. Many firms believe that disclosures related to the income statement and the statement of cash flows generally should be presented for all periods; however, disclosures related to the balance sheet should be evaluated to determine whether they are still meaningful.

The notes, as an integral part of the financial statements, are the responsibility of the client even though the practitioner may assist with, or totally prepare, the statements and notes. The wording of the notes should follow this principle, and such words as "we," "us," "client," and "our," should not be used so as to avoid any implication of reference to the CPA. Use of "the Company," "the Corporation," or "Management" is a more appropriate way of referring to the client.

Format

Generally, notes are presented separately after the basic financial statements. The notes should be arranged in the same order as they appear in the statements, and it is a good idea for each note to bear a heading that corresponds to a balance sheet or income statement caption, if possible.

When the number of notes are few, it may be appropriate to present them at the bottom of the first financial statement to which they refer. If the note also applies to other statements, a reference to it (such as "See Note A on the Balance Sheet") should be made on those statements.

Title

When the notes are presented on separate pages rather than on the face of the statements, the pages should be appropriately titled as follows:

> ABC CORPORATION
> NOTES TO FINANCIAL STATEMENTS
> December 31, 20X2

When a single statement is presented and notes are presented on separate pages, the title should include the name of the statement rather than the general term "financial statement."

> ABC CORPORATION
> NOTES TO BALANCE SHEET
> December 31, 20X2

When the financial statements exclude substantially all disclosures but do include selected notes, the separate pages of the notes should be labeled as follows:

> ABC COMPANY
> SELECTED INFORMATION—Substantially All Disclosures Required by
> Generally Accepted Accounting Principles Are Not Included
> December 31, 20X2

In practice, some firms include the balance sheet date in the caption while others do not.

Content (Disclosure Checklists)

The notes should include disclosures required by GAAP that are not presented on the face of the statements or in the summary of significant accounting policies. In addition, the practitioner should keep in mind that the financial statements should include all information necessary to prevent them from being misleading regardless of whether the disclosure is specifically required by accounting pronouncements. A listing of all possible required disclosures is not practical and would be outside the scope of this course; however, more information about such disclosures is available in *PPC's Guide to Compilation and Review Engagements.*

Referencing Accounting Standards in the Notes

FASB ASC 105-10-05-5 states that Accounting Standards Updates (ASUs), which are issued by the FASB to update the FASB Accounting Standards Codification (ASC) with new or amended guidance, are not considered authoritative in their own right. Since individual ASUs are not authoritative, this course recommends that they not be cited in disclosures to financial statements. Thus, the illustrative notes in this course follow this guideline. However, in practice, some financial statement preparers do refer to individual ASUs when discussing changes in accounting and disclosure requirements. Practice can be expected to evolve in this area.

SELF-STUDY QUIZ

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

4. In addition to currency an entity has on hand, which of the following would be considered *cash*?

    a. Treasury bills.

    b. Commercial paper.

    c. Investments that mature in over three months.

    d. Certificates of deposit.

5. Paisley Products pays dividends to its stockholders. How would this be classified on its statement of cash flows?

    a. Cash payments for operating.

    b. Cash payments for investing.

    c. Cash payments for financing.

    d. Noncash investing and financing transactions.

6. Which of the following is considered part of the cash flows from operating activities?

    a. Accruals, deferrals, allocations such as depreciation, and other amounts that are not derived from cash receipts and payments.

    b. Amounts that come from an entity's normal procedures for delivering/producing goods for sale or providing services.

    c. Amounts from acquiring and selling or disposing of productive assets that are supposed to generate revenue over a long period of time.

    d. Amounts obtained from owners in return for providing them with a return on (and a return of) their investment.

7. Which of the following statements best describes the summary of significant accounting policies?

    a. The summary can be omitted if the financial statement presentation only includes one statement.

    b. Only entities that operate on a for-profit basis are required to include this summary in their statements.

    c. The summary describes accounting principles used by the entity, including judgments on how appropriate they are.

    d. The disclosure is required to be presented separately in the notes to the financial statements.

SELF-STUDY ANSWERS

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

4. In addition to currency an entity has on hand, which of the following would be considered *cash*? **(Page 24)**

   a. Treasury bills. [This answer is incorrect. Based on the definitions provided in FASB ASC 230-10-20, Treasury bills are an example of a *cash equivalent.* Cash equivalents are short-term, highly liquid investments that (1) are readily convertible to known amounts of cash and (2) are so near to their maturity that they present insignificant risk of changes in value because of changes in interest rates.]

   b. Commercial paper. [This answer is incorrect. Commercial paper is an example of a *cash equivalent,* not cash, per the definitions outlined in FASB ASC 230-10-20.]

   c. Investments that mature in over three months. [This answer is incorrect. According to FASB ASC 230-10-20, which defines the terms *cash* and *cash equivalents,* short-term investments with original maturities of three months or less are considered cash equivalents. Therefore, investments that mature in more than three months would not qualify as either cash or a cash equivalent.]

   d. Certificates of deposit. [This answer is correct. According to FASB ASC 230-10-20, cash includes not only currency on hand but demand deposits with banks or other financial institutions. These accounts must have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively withdraw funds at any time without prior notice or penalty. Certificates of deposit, money market accounts, and repurchase agreements that have such characteristics can then be considered cash.]

5. Paisley Products pays dividends to its stockholders. How would this be classified on its statement of cash flows? **(Page 25)**

   a. Cash payments for operating. [This answer is incorrect. Examples of cash payments for operating include, among other things, payments for inventory, wages, general and administrative expenses, and taxes. They do not include dividends like the ones that Paisley Products paid in this scenario.]

   b. Cash payments for investing. [This answer is incorrect. Cash payments for investing include those for property and equipment, certain securities, and loans made to others. The dividends paid by Paisley Products in this scenario do not qualify under this category.]

   c. Cash payments for financing. [This answer is correct. A statement of cash flows has five basic elements: (1) cash flows from operating activities, (2) cash flows from investing activities, (3) cash flows from financing activities, (4) net change in cash during the period, and (5) supplemental disclosure of noncash investing and financing activities. Accordingly, all cash receipts and payments should be classified as operating, investing, or financing activities, and noncash transactions involving investing and financing activities should be disclosed separately rather than within the body of the statement. Examples of cash payments for financing include dividends, repayment of amounts borrowed, and Treasury stock.]

   d. Noncash investing and financing transactions. [This answer is incorrect. Examples of noncash investing and financing transactions include, among other things, acquiring nonoperating assets by assuming liabilities or exchanging assets and issuing stock in exchange for subscriptions receivable or other noncash consideration. Paying dividends with cash, as Paisley Products did in this scenario, would not be considered a noncash transaction.]

6. Which of the following is considered part of the cash flows from operating activities? **(Page 27)**

   a. Accruals, deferrals, allocations such as depreciation, and other amounts that are not derived from cash receipts and payments. [This answer is incorrect. Cash flows from operating activities exclude (1) amounts that are not derived from cash receipts and payments (e.g., accruals, deferrals, and allocations such as depreciation) and (2) amounts that are considered to be derived from investing or financing activities rather than operations.]

   b. Amounts that come from an entity's normal procedures for delivering/producing goods for sale or providing services. [This answer is correct. FASB ASC 230-10-20 defines cash flows from operating activities by exception; operating activities include all transactions that are not investing or financing activities. Generally, however, operating activities meet the following three criteria: (1) the amounts represent the *cash effects* of transactions or events, (2) the amounts result from a company's normal operations for delivering or producing goods for sale and providing services, and (3) the amounts are derived from activities that enter into the determination of net income.]

   c. Amounts from acquiring and selling or disposing of productive assets that are supposed to generate revenue over a long period of time. [This answer is incorrect. Cash flows from *investing activities* (not operating activities) include (1) lending money and collecting on loans, (2) acquiring and selling or disposing of securities, and (3) acquiring and selling or disposing of productive assets that are expected to generate revenue over a long period of time.]

   d. Amounts obtained from owners in return for providing them with a return on (and a return of) their investment. [This answer is incorrect. According to FASB ASC 230-10-20, *financing activities* (not operating activities) include (1) obtaining resources from owners and providing them with a return on, and a return of, their investment; (2) borrowing money and repaying amounts borrowed or otherwise settling the obligation; (3) obtaining and paying for other resources from creditors on long-term credit; and (4) receiving resources from donors with use stipulated for long-term purposes.]

7. Which of the following statements best describes the summary of significant accounting policies? **(Page 32)**

   a. The summary can be omitted if the financial statement presentation only includes one statement. [This answer is incorrect. A summary of significant accounting policies is required by GAAP when financial statements that purport to present financial position (balance sheet), results of operations (statement of income), or cash flows (statement of cash flows) are issued. When only one of these statements is issued, a summary of accounting policies pertinent to that statement is required.]

   b. Only entities that operate on a for-profit basis are required to include this summary in their statements. [This answer is incorrect. The disclosure of significant accounting policies is required under GAAP for financial statements of not-for-profit entities as well as for profit-oriented entities.]

   c. The summary describes accounting principles used by the entity, including judgments on how appropriate they are. [This answer is correct. FASB ASC 235-10 states that disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, results of operations, or cash flows. In general, the disclosure should encompass important judgments as to appropriateness of principles related to recognition of revenue and allocation of asset costs into current and future periods.]

   d. The disclosure is required to be presented separately in the notes to the financial statements. [This answer is incorrect. Significant accounting policies can be presented on the face of the statements, as part of individual notes to the financial statements, or in a separate note titled "Summary of Significant Accounting Policies." FASB ASC 235-10-50-6 expresses a preference for the single note, but it is not required.]

INCLUDING SUPPLEMENTARY OR OTHER INFORMATION IN THE FINANCIAL STATEMENTS

General

The unaudited financial statements of a nonpublic entity often include detailed schedules, summaries, comparisons, or statistical information that are not part of the basic financial statements. This information, which is not required for a fair presentation in accordance with GAAP, is often useful to the owners or management and, in some cases, is prepared especially for creditors. As mentioned earlier in this lesson, information required by GAAP should be presented on the face of the financial statements or in the notes. Supplemental schedules should *not* be used to present information required by GAAP such as future minimum lease payments and five-year maturities of long-term debt. Forecasts or projections that accompany historical financial statements are normally not considered supplementary or other information. *PPC's Guide to Forecasts and Projections* discusses the accountant's responsibility for such information. However, budgets for an expired period of time are not prospective data, i.e., they are considered supplementary information and should be reported on in accordance with AR-C 80.34–.36 and AR-C 90.80–.82.

Content

The decision to present supplementary information is sometimes made at the suggestion of the CPA. The content and extent of supplementary information can vary widely from details of amounts presented in the financial statements to presentation of ratios and analyses. The content should be tailored to fit the needs of the particular client and the statement users. The following items might appear as supplementary information:

a. Budgets for an expired period.

b. Cost of goods sold schedule.

c. Manufacturing expense schedule.

d. Selling expenses.

e. General and administrative expenses.

f. Details of marketable securities.

g. Property and equipment schedule.

h. Condensed historical financial statements.

i. Aging analysis of accounts receivable.

j. Department earnings statements.

k. Details of consolidation.

l. Organizational data (history, etc.).

m. Comparative statements expressed in percentages.

n. Details of sales by product line, territory, or salesman.

For reviewed financial statements, the company may want to present some of the analyses made during the accountant's review such as:

a. Rates of inventory turnover.

b. Days of sales in accounts receivable.

c. Gross profit comparisons.

Presentation

Normally, supplementary information is segregated from the basic financial statements, i.e., presented on separate pages. It is a best practice to present the supplementary schedules after the basic financial statements and notes and, ordinarily, be preceded by a title page that is marked:

SUPPLEMENTARY INFORMATION

If a separate report on the supplementary information is to be presented, it should follow the title page.

The order of presentation can vary widely but should follow some logical pattern. One such method is to present the schedules in the order in which the subject appears in the basic financial statements. If many schedules are presented, the CPA may find it useful to include a table of contents in the financial statements.

Reporting

The accountant must describe in his report on the financial statements, or in a separate report, the degree of responsibility, if any, he takes with regard to supplementary information.

Percentages

Percentages presented on the statement of income (as is commonly the case with computer-prepared statements) do not seem to constitute supplementary information for purposes of the reporting requirements applicable to supplementary information.

Charts and Graphs

The unaudited financial statements of a nonissuer sometimes include financial information presented in the form of a chart or graph. It is a good idea for such information to typically be considered supplementary information and reported on as such. An in-depth discusion of how to report on such information is beyond the scope of this course, but more information is available in *PPC's Guide to Compilation and Review Engagements*.

Details of Consolidation or Combination

When a company conducts its business through divisions, branches, or subsidiaries, the consolidated or combined financial statements generally are presented as the basic financial statements and frequently are accompanied by supplementary information that provides details about individual branches, divisions, or subsidiaries.

Supplementary schedules that provide details of consolidated financial statements are referred to as consolidating financial statements and should be appropriately titled such as consolidating balance sheet or consolidating statement of income.

Supplementary information showing details of other company groupings, for example, a group linked by common ownership or control rather than parent-subsidiary relationships, are referred to as combining financial statements. When combining financial statements are prepared, the individual statements should bear appropriate titles such as combining balance sheet or combining statement of income.

Schedule Headings

Each schedule should be headed with a descriptive title that distinguishes it from the basic financial statements. Normally, supplementary schedules are not referred to as "statements" to avoid confusing them with basic financial statements.

XYZ COMPANY
ANALYSIS OF COST OF SALES
Year Ended December 31, 20X2

Reference to Report

While the SSARS have no requirement for a reference to the accountant's report, some accountants believe that each supplementary schedule should include a reference to the accountant's report. AR-C 80.A43 and AR-C 90.A134 both state that the accountant may choose to include a reference to the accountant's report on each page of the supplementary information in order to avoid any inadvertent reliance on the supplementary information if the accountant's report were to become detached. For example, some accountants may choose to include the reference when reviewed financial statements are accompanied by supplementary schedules, which are not subjected to the accountant's review procedures as the level of service provided on the supplementary schedules is lower than that provided on the basic financial statements. An appropriate reference when the accountant's report on the supplementary information is part of the report on the basic financial statements would be—

See accountant's report.

If a separate accountant's report on the supplementary information is presented, the reference would be—

See accountant's report on supplementary information.

Additional discussion on this topic appeared earlier in this lesson.

DEALING WITH RISKS AND UNCERTAINTIES

FASB ASC 275, *Risks and Uncertainties*, requires disclosures about risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term. In addition, it requires communication of the inherent limitations of financial statements.

GAAP does not require disclosure of all risks and uncertainties, which would be an impossible task, but requires disclosure of certain risks and uncertainties that meet specified criteria. FASB ASC 275-10-50-1 requires disclosure in the following four areas:

- Nature of operations, including activities in which the entity engages if principal operations have not commenced.
- Use of estimates when preparing the financial statements.
- Certain significant estimates.
- Current vulnerability as a result of certain concentrations.

The first two disclosures, nature of operations and use of estimates, are required for all financial statements. The second two are required only for estimates and concentrations that meet specified criteria.

Certain risks and uncertainties are explicitly excluded from the disclosure requirements. These include risks and uncertainties that might be associated with the following:

- Management or key personnel (for example, loss of the owner/manager of a small business).
- Proposed changes in government regulations.
- Proposed changes in accounting principles.
- Deficiencies in a company's internal control.
- Acts of God.
- War.
- Sudden catastrophes.

The following paragraphs provide a brief overview of the four areas of disclosure required by FASB ASC 275-10-50. Additional guidance and case studies on applying FASB ASC 275-10-50 is found in *PPC's Guide to Preparing Financial Statements*. This *Guide* can be ordered by calling (800) 431-9025 or at **tax.thomsonreuters.com**.

Nature of Operations

GAAP requires that all financial statements include a description of the major products or services the reporting entity sells or provides. It also requires disclosure of the entity's principal markets, including the locations of those markets. Finally, if the entity operates in more than one business, disclosures must indicate the relative importance of each business and the basis for determining relative importance. Relative importance can be based on such things as assets, revenues, or net income, and does not have to be quantified. It can be communicated by using terms such as "predominantly," "about equally," or "major."

Many financial statements already disclose the nature of the company's operations, including its major products or services. Many financial statements also disclose concentrations of credit risk. If all or most of a company's sales are credit sales, the disclosure may accomplish the disclosure of the company's principal markets. Consequently, GAAP disclosure requirements may require only minor modification of existing disclosures. Additional modification might be necessary if, for example, the company operates in more than one business.

Use of Estimates

Financial statement disclosures should include an explanation that preparation of financial statements requires the use of management's estimates. GAAP acknowledges that the disclosure will usually be standardized (that is, boilerplate). The disclosure should normally be included in the summary of significant accounting policies.

Certain Significant Estimates

FASB ASC 275-10-50-8 requires additional disclosures for certain *significant* estimates. The additional disclosures are required when the estimate meets *both* of the following criteria:

- It is at least reasonably possible that the estimate *of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements* will change in the near term *due to one or more future confirming events*. [Emphasis added.]

- The effect of the change would be material to the financial statements.

Since any change in the estimate would be accounted for prospectively, the disclosure serves to notify financial statements users that there is at least a reasonable possibility that a variance from an estimate in the current financial statements could materially affect future periods. Also, the disclosure notifies financial statement users that recorded amounts are not necessarily carved in stone, may be subjective, and could be subject to material change—even though they comply with GAAP.

Reasonably Possible. While the "existing condition" requirement helps to narrow the range of estimates that meet the criterion, the range is still very broad. That is primarily because the definition of *reasonably possible*, which has the same meaning in FASB ASC 275-10-20 as it does in FASB ASC 450, *Contingencies*. FASB ASC 450-20-20 provides the following definitions:

- *Probable.* The future event or events are likely to occur.

- *Reasonably Possible.* The chance of the future event or events occurring is more than remote but less than likely.

- *Remote.* The chance of the future event or events occurring is slight.

Consequently, *reasonably possible* means anything more than remote but less than probable.

Near Term. This term is defined in the FASB ASC 275-10-20 glossary "as a period of time not to exceed one year from the date of the financial statements."

Material. The second criterion listed above for a significant estimate is that the effect of the change would be material to the financial statements. (See the discussion of materiality later in this lesson.) FASB ASC 275-10-50-14 goes on to state—

> Whether an estimate meets the criteria for disclosure under this Subtopic does not depend on the amount that has been reported in the financial statements, but rather on the materiality of the effect that using a different estimate would have had on the financial statements. Simply because an estimate resulted in the recognition of a small financial statement amount, *or no amount*, does not mean that disclosure is not required under this Subtopic. [Emphasis added.]

Consequently, disclosure might be required even if no estimate is recognized in the financial statements (that is, the estimate is zero).

Estimates to Which the Disclosure Requirement Applies. The types of estimates that should be considered for disclosure are those used in the determination of the carrying amounts of assets or liabilities or in the disclosure of gain or loss contingencies. In other words, the disclosure requirements relate to estimates used to determine (a) recorded amounts and (b) disclosures of gain or loss contingencies. The disclosure requirements do not apply to estimates such as those used when disclosing the fair value of financial instruments in accordance with FASB ASC 825-10-50. Also, as noted previously, disclosure should generally be considered more closely when a condition, situation, or set of circumstances makes an estimate more susceptible to change than it ordinarily would be. In addition, the more critical an estimate is to the financial statements, the more likely it is that disclosure is needed. As a practical matter, the disclosure can be used to provide an early warning to financial statement users that certain estimates, based on the best information available, are still somewhat soft and changes in them may affect future financial statements.

Disclosure Requirements. If an estimate meets the criteria for disclosure, the disclosure must—

- describe the nature of the uncertainty, and
- indicate that it is at least reasonably possible that a change in the estimate will occur in the near term.

The terms *reasonably possible* and *near term* may not be fully understood by financial statements users, and alternative language can be used. GAAP states that use of the words *reasonably possible* is not required. As long as it is clear that a change in the estimate might occur, alternative wording is appropriate. Phrases such as *could* and *may* can be used instead. As an alternative to *near term*, phrases such as *in the next year* or *over the next year* can be used.

In addition, if the estimate involves a loss contingency subject to FASB ASC 450, those disclosure requirements must also be considered. As a result, the disclosure must include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be subject to change is encouraged but not required.

Current Vulnerability Due to Concentrations

FASB ASC 275-10-50-16 through 50-21 also requires disclosure of concentrations that meet certain criteria. The types of concentrations that must be *considered* for disclosures are as follows:

- Concentrations in the volume of business transacted with a particular customer, supplier, or lender.
- Concentrations in revenue from particular products or services.
- Concentrations in the available sources of supply of materials, labor, or services; or of licenses or other rights used in the entity's operations.
- Concentrations in the market or geographic area in which an entity conducts its operations.

Certain of these concentrations are already disclosed in some financial statements. One example is economic dependence on major customers or suppliers. While there has been some disagreement as to whether economic dependence disclosures are still required for nonissuers, GAAP requires them in all financial statements (if the criteria for disclosure listed below are met). Another example is disclosure of concentrations of credit risk. Although concentrations of financial instruments are specifically excluded from the disclosure requirements, disclosure of market or customer concentrations may also provide the necessary disclosure for credit risk concentrations.

What Is a Concentration? FASB ASC 275-10-50-16 states that—

> Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification.

A concentration is of concern when it involves something that cannot be easily replaced. If, for example, a company purchases most of its raw material from a single supplier, that is not a concentration that requires disclosure unless the supplier cannot be easily replaced. Concentrations may not necessarily be identifiable solely on the basis of dollars. For example, if a company purchases only a small amount of raw material from a supplier, but that raw material is critical to the company's production process, the company is vulnerable to the concentration if the supplier cannot be easily replaced.

Criteria for Disclosure. Disclosure of concentrations is required only if certain criteria are met. Those criteria are as follows, and they must *all* be met for disclosure to be required:

- The concentration exists at the date of the financial statements (the balance sheet date).
- The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.
- It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

The criteria are similar in some ways and use some of the same wording as the criteria in the "Certain Significant Estimates" discussion for disclosing certain significant estimates. For example, occurrence must be "at least reasonably possible," and the criteria are to be considered "based on information known prior to issuance of the financial statements." These and other terms used similarly in both sets of criteria are discussed in prior paragraphs.

Severe Impact. *Severe impact* is defined in FASB ASC 275-10-20 as follows:

> A significant financially disruptive effect on the normal functioning of the entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the entity . . . . The concept of severe impact, however, includes matters that are less than catastrophic.

Thus, severe impact is a significant financially disruptive effect on the normal functioning of the company. It's more than just material, but less than catastrophic. An example of a catastrophic event is one that would result in bankruptcy, such as the inability to obtain financing.

Disclosures. For concentrations meeting the criteria for disclosure listed above, disclosures must include information that is adequate to inform financial statement users of the general nature of the risk associated with the concentration. Additional specific disclosures are required for concentrations of labor subject to collective bargaining agreements and for foreign operations.

Summary of Disclosure Requirements. Exhibit 1-3 summarizes the disclosure requirements for significant risks and uncertainties. Failure to comply with the disclosure requirements constitutes a GAAP disclosure departure.

Exhibit 1-3

Disclosing Significant Risks and Uncertainties

	Nature of Operations	Use of Estimates	Certain Significant Estimates	Concentrations
When to Disclose?	Always.	Always.	• It is at least reasonably possible that the estimate of the effect on the financial statements of an existing condition will change in the near term due to future confirming events. AND • The change in estimate would have a material effect on the financial statements.	• A concentration exists at the financial statement date. AND • The concentration increases the company's vulnerability to the risk of a near-term severe impact. AND • It is reasonably possible that the events able to cause the severe impact could occur in the near term.
Threshold for Disclosing?	N/A	N/A	Potential *material* effect on financial statements.	Potential *severe* impact to the company.
What to Disclose?	• Description of products or services. • Relative importance of each business. • Basis used to determine relative importance of each business. • Principal markets and locations of the markets.	Explanation that management estimates are used in preparing financial statements.	• Nature of uncertainty. • An indication that it is at least reasonably possible that a change in the estimate will occur in the near term.	• Concentrations in business volume conducted with a particular customer, supplier, lender, grantor, or contributor. • Concentrations in revenue from particular products, services, or fund-raising events. • Concentrations in available sources of materials, labor, services, licenses, or rights. • Concentrations in the geographic area or markets in which a company operates.

* * *

Wording the Disclosures. Applying the disclosure requirements requires significant judgement on the part of both the accountant and the client. However, there are only disclosure requirements. It does not require amounts to be recorded in the financial statements. For that reason, an approach of "when in doubt, disclose" is generally recommended. In a sense, by making the disclosure, the client, as well as the accountant, transfers some of the risk due to uncertainties in the financial statements to the financial statements users themselves. By not making the disclosures, however, the client and the accountant forego an opportunity to reduce the risk that a user may successfully assert in litigation that the disclosures should have been made.

Going Concern Uncertainty

FASB ASC 205-40 provides guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related disclosure requirements. The accounting guidance is effective for annual periods ending after December 15, 2016, and for annual periods and interim periods thereafter. The key features of FASB ASC 205-40 are as follows:

- Defines the term *substantial doubt*.
- Requires management to evaluate whether conditions and events raise substantial doubt at both interim and annual period ends.
- Requires management's evaluation to be based on an assessment of the effect of known and reasonably knowable conditions and events at the date the financial statements are available to be issued for a period one year after that date.
- Identifies principles for considering whether management's plans mitigate the substantial doubt.
- Requires certain disclosures when consideration of management's plans alleviates substantial doubt.
- Requires an explicit statement by management that there is substantial doubt as well as other disclosures when substantial doubt is not alleviated.

According to the guidance in AR-C 90.65–.68, a *reasonable period of time* is defined as the same period of time for which management must assess the going concern assumption if that period is specified by the applicable financial reporting framework, or one year from the date of the financial statements being reviewed if the framework does not specify a time period. (GAAP specifies the time period as one year after the date the financial statements are available to be issued.) AR-C 90 also contains going concern application guidance with examples of conditions or events that may indicate a going concern and illustrative emphasis of matter language that may be used if there is an uncertainty about the entity's ability to continue as a going concern. AR-C 80.15 indicates that if the accountant becomes aware that the financial statements are misleading, he or she should propose revisions to management. An undisclosed uncertainty about the entity's ability to continue as a going concern is listed in AR-C 80.A15 as an example of misleading financial statements. If such a situation exists, the accountant may suggest additional disclosures be made.

CONSIDERATIONS FOR DERIVATIVE INSTRUMENTS

FASB ASC 815, *Derivatives and Hedging*, requires *all* entities to measure derivative instruments at fair value and recognize them as either assets or liabilities in the balance sheet. The accounting requirements related to derivatives are very complex and beyond the scope of this course; therefore, this discussion is intended to provide accountants with only a general understanding of the accounting rules for derivative instruments in accordance with FASB ASC 815. *PPC's Guide to Preparing Financial Statements* provides an in-depth discussion on accounting for derivatives.

What Is a Derivative?

FASB ASC 815-10-15-83 defines a derivative as a financial instrument or other contract with all three of the following characteristics:

a. It has at least one underlying (such as an interest rate, security price, commodity price, foreign exchange rate, or other variable) and at least one notional amount (such as specified number of currency units, shares, bushels, pounds or other units) or payment provisions (such as a fixed or determinable settlement if the underlying performs in a specified manner) or both.

b. It requires no initial net investment or an initial net investment less than would be required for other types of contracts expected to respond similarly to changes in market factors.

c. Its terms require or allow net settlement; it can readily be settled net by a method outside the contract; or it provides for delivery of an asset that puts the recipient in a position similar to net settlement.

A derivative instrument may be a stand-alone contract or it may be embedded in another contract, such as a loan agreement, bond, insurance contract, or lease agreement. In some cases, GAAP requires the embedded derivative to be accounted for separately from the host contract. An issuer of a loan commitment related to the origination of a mortgage loan to be held for sale must account for the loan commitment as a derivative instrument.

Accounting for Derivatives

Derivative instruments are measured at fair value and reported in the balance sheet as assets or liabilities. Accounting for gains and losses (that is, changes in fair value) depends on the intended use of the derivative. Gains and losses on derivative instruments not designated as hedging instruments should be recognized in earnings in the period of the change in fair value. For example, an investment in a speculative option to buy units of foreign currency should be reported as an asset and adjusted to its fair value, with changes in fair value included in net income. Accounting for gains and losses on hedging instruments depends on the type of hedge, as follows:

a. *Fair Value Hedge.* If the derivative is intended to hedge the exposure to changes in the fair value of a recognized asset or liability or firm commitment, the gain or loss on both the hedge and the hedged item should be included in earnings in the period of the change. This treatment is also applicable to a derivative designated as a hedge of a foreign currency exposure of an unrecognized firm commitment or a recognized asset or liability (including an available-for-sale security).

b. *Cash Flow Hedge.* If the derivative is intended to hedge the exposure to variable cash flows of a forecasted transaction, the gain or loss on the hedge generally should be included as a component of other comprehensive income until the forecasted transaction affects earnings. A hedge of a foreign currency exposure of a foreign-currency-denominated forecasted transaction should also be treated as a cash flow hedge.

c. *Foreign Currency Hedge.* If the derivative is intended to hedge the foreign currency exposure of a net investment in a foreign operation, the gain or loss in fair value should be reported in other comprehensive income as part of the cumulative translation adjustment.

There are complex rules for determining whether a derivative qualifies for hedge accounting and also specific documentation requirements for derivatives designated as hedging instruments. Those requirements are discussed in more detail in *PPC's Guide to Preparing Financial Statements*.

Disclosure Requirements

FASB ASC 815-10-50 requires disclosure of the objectives for holding hedging instruments, the risk management policy for each type of hedge, and the purpose of derivative instruments not designated as hedging instruments. It also requires disclosing information about changes in a derivative's fair value that relate to its ineffectiveness as a hedge and that are excluded from the assessment of hedge ineffectiveness. Additional disclosures may also be required.

Common Uses of Derivatives

Derivatives offer a way for small and medium-sized entities to manage their exposure to risks and to speculate on changes in market conditions. Common derivatives, often referred to as *plain vanilla* derivatives, are available through banks and other sources. The following paragraphs explain common uses of an interest rate swap, options to establish a range of interest rates, a forward contract to buy foreign currency, and an option to buy foreign currency.

Interest Rate Swap

An interest rate swap is a derivative that may be used to convert a variable interest rate to a fixed rate or vice versa. To illustrate, assume that an entity has a $100,000 note that is payable to a bank in three years and bears interest annually at a rate equal to London Interbank Offered Rate (LIBOR) plus 3%. To help it stabilize cash flow requirements, the entity wants to fix its interest payments at 8%. It therefore enters into an interest rate swap contract with the bank under which the entity makes a small up-front payment and annually writes or receives a check equal to the difference between interest on $100,000 at a fixed rate of 8% and at LIBOR plus 3%.

The swap has each of the characteristics for a derivative discussed at the beginning of this section—

a. It has an interest rate underlying, and its notional amount is the $100,000 base on which interest receipts and payments are calculated.

b. It requires only a small initial net investment.

c. Net settlement is permitted by only receiving or paying cash for the effect of the difference between the two interest rates.

To illustrate how the swap operates, assume that shortly after the note was issued, LIBOR rose to 7% and that during the first year the note was outstanding, the variable rate was 10% (which equals the 7% LIBOR plus 3%). For the first interest payment—

- The entity owes the bank $10,000 for interest on the note (which is the product of the $100,000 principal balance and the 10% variable interest rate).

- Under the swap, the entity owes the bank $8,000 (which is the product of the $100,000 principal balance and the 8% fixed rate), and the bank owes the entity $10,000 (which is the product of principal and the variable interest rate). The entity therefore receives a $2,000 payment from the bank for the excess of the $10,000 due from the bank over the $8,000 due to the bank.

- The entity records interest expense of $8,000 for the excess of the $10,000 paid under the variable rate provision over the net $2,000 received under the swap agreement. That equals interest on the $100,000 principal balance at the 8% fixed rate the entity desired. The swap was, therefore, perfectly effective in hedging the effect of interest rate changes on the interest payments required under the entity's note.

Options to Establish a Range of Interest Rates

Derivatives written as options to establish a range of interest rates include a cap (a maximum rate), a floor (a minimum rate), and a collar (a maximum and a minimum rate). To illustrate, assume that an entity has a $100,000 note payable to a bank in two years, with interest due annually at the six-month LIBOR plus 3%. To protect itself from significant increases in LIBOR, the entity enters into a cap agreement with the bank whereby the bank (the writer) will pay the entity (the holder) the excess of LIBOR plus 3% over 11% (the cap rate) on $100,000. The entity pays a small premium for the cap agreement.

The cap agreement meets the requirements for a derivative because—

a. It has an underlying (the excess of the variable interest rate over 11%) and a notional amount (the $100,000 principal of the note).

b. It requires only a small initial investment.

c. Exercise of the cap only requires payment of the excess of actual interest over interest based on the cap rate. The notional amount is not paid.

The following examples illustrate how the cap works:

- If the six-month LIBOR at the end of the year is 6%, the entity owes the bank $9,000, which is the product of the $100,000 principal outstanding and the 9% variable rate resulting from adding 3% to the 6% LIBOR. The entity would not exercise its option to receive payment from the cap writer.

- If LIBOR is 9% at the end of the year, the entity owes the bank $12,000 (which is the product of $100,000 and the 12% rate resulting from adding 3% to the 9% LIBOR). The bank would then be required to pay the entity $1,000 under the cap agreement, which is the excess of the $12,000 interest due over the $11,000 cap imposed ($100,000 × 11%). The entity therefore incurs net interest expense of $11,000 because it paid the bank $12,000 and received $1,000 from the bank.

Forward Contract to Buy Foreign Currency

A forward contract to buy foreign currency is an agreement to buy a specified amount of foreign currency (the notional amount) at a specified exchange rate (the underlying) at a future date. To illustrate, assume that a U.S. subsidiary obtains a loan from its foreign parent that is denominated in the currency of the country in which the parent is located. The loan provides $150,000 and is due in two years. At the time of the loan, the exchange rate is 1 U.S. dollar for each 1.5 units of foreign currency ($1:1.5 FC). The loan therefore represents 100,000 units of foreign currency ($150,000 ÷ 1.5). If the exchange rate increases, more U.S. dollars will be required to buy the 100,000 units of foreign currency needed to settle the loan. To lock in an exchange rate for payment of the loan, the subsidiary enters into an exchange-traded futures contract to buy 100,000 units of foreign currency in two years at an exchange rate of 1.5.

If the exchange rate increases to 1.75, the entity will pay $175,000 to acquire the 100,000 foreign currency units (100,000 units × 1.75) needed to pay the loan, which is $25,000 higher than the original loan because of the .25 increase in the exchange rate from 1.5 to 1.75. However, to close the futures contract, in essence the subsidiary would—

a. Pay $150,000 to the holder of the contract to acquire the 100,000 units of foreign currency at the 1.5 designated exchange rate (strike rate).

b. Sell those units for $175,000 because the market exchange rate is 1.75.

As a practical matter, the transactions will offset each other. As a result, the subsidiary will receive a $25,000 check for the excess of the $175,000 received for selling the 100,000 units of foreign currency in the open market over the $150,000 paid to acquire them from the holder of the futures contract. The result, then, is that the subsidiary paid $175,000 to acquire the 100,000 units of foreign currency it needed to pay the loan but recovered $25,000 of that from settling its position in the futures contract. The net $150,000 cost ($175,000 − $25,000) represents an effective exchange rate of 1.5 ($150,000 ÷ 100,000 FC) to acquire the 100,000 units of foreign currency. The futures contract was completely effective in locking in the 1.5 exchange rate.

If the exchange rate decreases to 1.25, the entity will pay only $125,000 to acquire the 100,000 foreign currency units (100,000 × 1.25) needed to pay the loan, which is $25,000 lower than the original loan because of the .25 decrease in the exchange rate from 1.5 to 1.25. However, the $25,000 gain is offset by the $25,000 loss from closing the futures contract because the $150,000 paid for the 100,000 units under the futures contract exceeds the $125,000 received from selling those units at the current exchange rate of 1.25 by $25,000. The net result is the same result as in the previous paragraph, the entity achieved the desired effective exchange rate of 1.5.

Option to Buy Foreign Currency

An entity may speculate on changes in exchange rates through an option to buy foreign currency. To illustrate, assume that a bank pays the entity a nonrefundable fee in exchange for an option to sell the entity a prescribed number of units of foreign currency during the next year. The exchange rate on which the option is based determines the number of units of foreign currency needed to buy one U.S. dollar. Therefore, if the exchange rate increases, the cost in U.S. dollars of buying units of foreign currency decreases.

Under the option, the bank will sell the entity units of foreign currency at a fixed exchange rate as long as the current exchange rate exceeds that rate; otherwise, it will not. The derivative is purely speculative—the bank profits if the exchange rate rises, and the entity profits if it does not. To illustrate results under the option, assume that (a) the exchange rate is currently 1.7, (b) the fixed rate is 1.5, and (c) the bank sells 10,000 units. (Results are rounded to the nearest hundred dollars to simplify the illustration.)

- The bank buys the units for $5,900 (10,000 units ÷ 1.7) and sells them to the entity for $6,700 (10,000 units ÷ 1.5), yielding a gain of $800 ($6,700 − $5,900).

- The entity realizes an economic loss of $800 because it pays $6,700 to buy the foreign currency units needed to settle an obligation of $5,900 determined using the current exchange rate. (As a practical matter, however, the entity has a total loss under the option arrangement only if losses from increases in the exchange rate above 1.5 exceed the nonrefundable fee received from the bank.)

The Simplified Hedge Accounting Approach

FASB ASC 815-20-25 provides an additional hedge accounting alternative for certain receive-variable pay-fixed interest rate swaps that a private company enters into for the purpose of converting a variable-rate loan into a fixed-rate loan. If certain conditions are met, the hedge accounting alternative serves as a practical expedient to qualify for cash flow hedge accounting.

The hedge accounting alternative, referred to as the *simplified hedge accounting approach* in the FASB Codification, is available to private companies (except for financial institutions) for any receivable-variable, pay-fixed interest rate swap, provided that all of the following conditions are met:

- Both the variable rate on the swap and the loan are based on the same index and reset period (such as a one-month LIBOR).

- The terms of the swap are typical (that is, it would be considered a plain-vanilla swap) and there is no cap or floor on the variable interest rate of the swap unless the loan has a comparable cap or floor.

- The repricing and settlement dates for the swap and the loan are the same or within a few days of each other.

- The swap's fair value at inception is at, or near, zero.

- The swap's notional amount agrees to the principal amount of the borrowing being hedged.

- All interest payments on the borrowing during the term of the swap are designated as hedged.

Instead of measuring a designated swap at fair value, the simplified hedge accounting approach under FASB ASC 815-10-35-1A provides a private company the option to measure the designated swap at its settlement value. The primary difference between fair value and settlement value is that settlement value does not consider nonperformance risk.

Under FASB ASC 815-20-25-3, for a new swap, an entity must satisfy the documentation requirements at the inception of the hedge. The simplified hedge accounting approach under FASB ASC 815-20-25-131C relaxes the timing of the required hedge documentation to the date on which the first annual financial statements are available to be issued after hedge inception.

The simplified hedge accounting approach does not change or add any hedge accounting or fair value disclosure requirements to FASB ASC 815 or FASB ASC 820, *Fair Value Measurement*, other than to indicate that an entity may substitute a swap's settlement value for its fair value within the disclosures. However, the entity should clearly identify any amounts disclosed at settlement value and separate them from any amounts disclosed at fair value. All other requirements in FASB ASC 815 for cash flow hedge accounting apply for the simplified hedge accounting approach.

CONSIDERATIONS FOR ACCOUNTS RECEIVABLE

Presentation and Disclosure Considerations for Receivables

Small and midsize nonpublic entities typically have a variety of receivables. Generally accepted accounting principles for receivables generally focus on their realizability. The possibility that some or all of a receivable will not be realized is a contingency and accordingly:

a. Provision should be made for realization losses that are probable and can be reasonably estimated. If a single point estimate cannot be made, consideration should be given to whether there is a range of possible losses. If there is a range and one amount in the range is better than any other amount, that amount should be used for the estimate. Otherwise, the lowest amount in the range should be used.

b. Losses that are probable but cannot be reasonably estimated and losses that are reasonably possible should be disclosed.

Applying those principles to portfolios of receivables typically involves breaking the portfolio into two strata—individual receivables with special characteristics, which are evaluated separately, and all other receivables, which are evaluated together as a group.

A summary of the presentation and disclosure considerations for receivables follows.

a. If the entity provides short-term or long-term financing to customers for sales of goods and services:

    (1) The major categories of balances due under the financing arrangements should be presented separately in the balance sheet or should be disclosed in the notes to the financial statements.

    (2) If the arrangements are interest-bearing, the following items should be disclosed:

        (a) The method used for recognizing interest income.

        (b) The policies for when to recognize interest on delinquent balances.

        (c) The carrying amount of balances for which interest is not being recognized.

        (d) The carrying amount of balances that are past due 90 days or more and still accruing interest.

    (3) If balances have been factored and the conditions for sale accounting have been met, the aggregate amount of gains or losses should be presented separately in the financial statements or disclosed in the notes to the financial statements.

b. The following amounts should be included in determining the carrying amount of the related receivables:

    (1) Deferred fees or costs.

    (2) Discount from imputing interest.

    (3) Unearned interest included in the face of recorded receivables.

c. Gross profit deferred under the installment method should be offset in determining the carrying amount of the related receivables.

d. The following amounts included in determining the carrying amount of receivables should be disclosed:

    (1) Deferred fees and costs.

    (2) Deferred gross profit.

    (3) Discount from imputing interest.

e. Losses that are probable but cannot be reasonably estimated and losses that are reasonably possible should be disclosed.

f. Amounts due from officers, employees, or affiliates should be presented separately in the balance sheet or disclosed in the notes to the financial statements.

g. If the balance sheet is presented in a classified format, amounts due from officers, employees, affiliates, and others should be included in current assets only if they are collectible in the ordinary course of business within a year.

h. Significant concentrations of credit risk arising from receivables should be disclosed.

GAAP also requires disclosures about credit risk considerations for trade receivables on a disaggregated basis. FASB ASC 310-10-50 requires disclosures by *portfolio segment* and by *class of financing receivable*. A *portfolio segment* is defined as the level at which an entity develops and documents a systematic method for determining its allowance for credit losses, although *portfolio* is not defined. *Classes of financing receivables* generally are a disaggregation of a portfolio segment. The only portfolio of receivables small and midsize nonpublic entities typically have is from short-term financing provided to customers for the sale of goods and services. However, some small and midsize nonpublic entities have a portfolio of receivables from providing long-term financing to customers for the sale of goods and services, such as:

a. A dealership that offers long-term financing to customers with higher-than-normal credit risk.

b. An insurance broker that offers long-term premium financing to high-risk customers.

Certain disclosure requirements in FASB ASC 310-10-50 do not apply to short-term financing provided to customers for the sale of goods and services. For other receivables portfolios, GAAP requires disclosures such as the following:

a. Information disaggregated by type of trade receivable, including:

   (1) accounting policies for past due or delinquent balances,

   (2) the carrying amount of receivables for which interest is no longer being accrued, and

   (3) the carrying amount of receivables that are past due 90 days or more and still accruing interest.

b. An analysis of the age of the carrying amount of receivables that are past due by type of trade receivable.

c. Information about the factors the entity considers in providing an allowance for credit losses and changes in the allowance for credit losses during the period covered by the financial statements, disaggregated by type of trade receivable.

d. The credit quality indicator used by the entity, the carrying amount of the receivables by credit quality indicator, and when the information for each credit quality indicator was updated.

Accounting Policies for Trade Receivables and Credit Losses and Doubtful Accounts. It seems appropriate to disclose the policies through a relatively standard note in the summary of significant accounting policies, such as—

> Trade Accounts Receivable
>
> Trade accounts receivable are stated at the amount management expects to collect from outstanding balances. Management provides for probable uncollectible amounts through a charge to earnings and a credit to a valuation allowance based on its assessment of the current status of individual accounts. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to trade accounts receivable. Changes in the valuation allowance have not been material to the financial statements.

Depending on the facts and circumstances, management may conclude that a valuation allowance is unnecessary, for example, because—

- Substantially all of the entity's credit sales are to a small number of customers who have a history of paying promptly.
- Management considered subsequent collection results and wrote off all year-end balances that were not collected by the time the financial statements were issued.
- The entity's customer base is relatively stable, management closely monitors outstanding customer balances, collection losses have historically been immaterial, and management is not aware of customer disputes or financial difficulties.

The following is an example of the accounting policy disclosure when management has concluded that a valuation allowance is unnecessary.

> Customer Accounts Receivable
>
> Customer accounts receivable are reported at the amount management expects to collect on balances outstanding at year-end. Management closely monitors outstanding balances and writes off, as of year-end, all balances that have not been collected by the time the financial statements are issued.

As another example—

> Trade Accounts Receivable
>
> Trade accounts receivable are stated at the amount management expects to collect from balances outstanding at year-end. Based on management's assessment of the credit history with customers having outstanding balances and current relationships with them, it has concluded that realization losses on balances outstanding at year-end will be immaterial.

Depending on the facts and circumstances, appropriate disclosure may also be provided in connection with other disclosures, such as disclosure of the nature of business. For example—

> NOTE B—NATURE OF BUSINESS AND CONCENTRATION OF CREDIT RISK
>
> ABC Company primarily provides advertising services for three entities located in Norton, Wyoming. While its credit risk for trade receivables is therefore concentrated, those receivables typically are collected within 60 days, and based on its assessment of current conditions management believes realization losses on amounts outstanding at year-end will be immaterial. Accordingly, trade receivables are reported at the amount of principal outstanding.

Amount of the Valuation Allowance and Material Changes in the Allowance. The amount of the valuation allowance can be disclosed through expansion of the trade receivables caption in the statement of financial position. However, if there are material changes in the valuation allowance, a table can be included in the notes to the financial statements that will disclose both the amount of the allowance and the changes in it. To illustrate—

NOTE X—CHANGES IN THE VALUATION ALLOWANCE FOR TRADE ACCOUNTS RECEIVABLE

Changes in the valuation allowance for trade accounts receivable are—

	20X1	20X0
Beginning balance	$ 80,000	$ 75,000
Provision for realization losses	95,000	80,000
Write-offs	(65,000)	(75,000)
Ending balance	$ 110,000	$ 80,000

Depending on the facts and circumstances, a change in the valuation allowance may be material in one year but not the other in comparative financial statements. An illustration of appropriate disclosure in that situation follows.

NOTE X—PROVISION FOR COLLECTION LOSS

Trade receivables are reported at their estimated net realizable value. Collection losses have historically been immaterial, and management concluded that, based on its review of material balances outstanding, a valuation allowance was needed only for the balance due from an entity that is experiencing financial difficulties. The $75,000 allowance is equal to one-half of the balance outstanding to provide for costs and concessions management believes are probable in negotiating settlement of the balance. Management will write off any balance that remains after it has exhausted all reasonable collection efforts and concludes that additional collection efforts are not cost-justified.

WHEN COMPANIES CHANGE THEIR FISCAL YEAR

A taxpayer may, with the permission of the Commissioner of the Internal Revenue Service, change its accounting period, e.g., from a December 31 year end to a July 31 year end. The IRS also requires taxpayers to change their fiscal year in certain circumstances, e.g., a corporation electing S corporation status is required to change to a December 31 year end unless it can show that the fiscal year is its natural business year (or the same tax year as that of shareholders who own more than 50% of its shares) or it pays a deposit. A change in fiscal year requires a short year (less than 12 months) tax return.

Almost universally, companies also change their fiscal year for financial reporting purposes when a change in tax year is adopted. Thus, the financial statements of the year of change would cover less than twelve months. Neither FASB ASC 250-10 nor other authoritative pronouncements discuss a change in a company's fiscal year.

A technical question and answer at Q&A 1800.03 indicates that, generally, the change should be disclosed in the current period to make the statements more meaningful. The Q&A seems to suggest that in disclosing the change in the fiscal year, the notes to the financial statements should state whether the effect was to decrease net income or increase net income, e.g., if, as a result of seasonal differences, the company normally experiences losses during the months not included in the current period. If the effect is measurable, i.e., the net income for the months excluded is known, the amount should be disclosed. It is a best practice to make disclosures whenever the year of change is presented, e.g., in comparative financial statements. It seems logical for short-year financial statements to be presented in comparative form with complete years so long as the change in fiscal year is disclosed, and the financial statements are appropriately captioned such as illustrated below.

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

	December 31, 20X2	June 30, 20X2

ABC COMPANY
STATEMENTS OF INCOME
Six Months Ended December 31, 20X2
and Year Ended June 30, 20X2

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

The following illustrates disclosing the change in the notes:

NOTE B—FISCAL YEAR CHANGE

Effective the calendar year beginning January 1, 20X3, the Company will change from a fiscal year end of June 30 to December 31. A six-month fiscal transition period from July 1, 20X2, through December 31, 20X2, precedes the start of the new calendar-year cycle.

SELF-STUDY QUIZ

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

8. Assuming all other criteria are met, when would a concentration need to be disclosed in the financial statements?

    a. The concentration is likely to occur in the financial period after the financial statement date.

    b. The concentration would make the entity vulnerable to a severe risk in the near future.

    c. The impact of the concentration would be catastrophic to the entity.

    d. There is a remote possibility that negative events associated with the concentration might occur.

9. What are derivatives commonly used for?

    a. Establishing a range of interest rates for an entity.

    b. Hedge an entity's exposure to variable cash flows in a forecasted transaction.

    c. Converting variable interest rates to fixed interest rates.

    d. Helping smaller entities manage risk exposure and speculate on the market.

10. Which of the following presentation and disclosure considerations applies to an entity's receivables?

    a. All potential losses that affect receivables need to be disclosed.

    b. Amounts due from affiliates should be included in current assets.

    c. Deferred fees or costs should be included in the related receivable's carrying amount.

    d. The aggregate amount of gains/losses for financing provided to customers should be presented separately.

11. Which of the following entities is most likely to disclose a valuation allowance for trade accounts receivable?

    a. Cardinal Frocks had credit sales only to a few customers that all have a history of prompt payments.

    b. Kalen Enterprises wrote off all its uncollected year-end balances before the financial statement date.

    c. Historically, Lansing-Ivy has a volatile customer base that is associated with a large amount of collection losses.

    d. The management of Major Pointe Sales closely monitors its outstanding customer balances and knows of no difficulties.

SELF-STUDY ANSWERS

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

8. Assuming all other criteria are met, when would a concentration need to be disclosed in the financial statements? **(Page 45)**

   a. The concentration is likely to occur in the financial period after the financial statement date. [This answer is incorrect. Disclosure of concentrations is required when, among other things, they exist at the date of the financial statements (the balance sheet date). Therefore, concentrations that could occur later would not need to be disclosed.]

   b. The concentration would make the entity vulnerable to a severe risk in the near future. [This answer is correct. Disclosure of concentrations is only required if certain criteria are met. All of the outlined criteria must be met for disclosure to be required. One such criterion is that the concentration makes the enterprise vulnerable to the risk of a near-term severe impact.]

   c. The impact of the concentration would be catastrophic to the entity. [This answer is incorrect. FASB ASC 275-10-20 specifies that the impact would need to be severe for disclosure to be required. Severe is greater than material, but less than catastrophic.]

   d. There is a remote possibility that negative events associated with the concentration might occur. [This answer is incorrect. For a concentration to require disclosure, one criterion that must occur is that it is at least reasonably possible (not remotely possible) that the events that could cause the severe impact will occur in the near term.]

9. What are derivatives commonly used for? **(Page 48)**

   a. Establishing a range of interest rates for an entity. [This answer is incorrect. Derivatives written as options establish a range of interest rates and include a cap (a maximum rate), a floor (a minimum rate), and a collar (a maximum and minimum rate). However, the use of option derivatives is different from common uses that apply to all derivatives.]

   b. Hedge an entity's exposure to variable cash flows in a forecasted transaction. [This answer is incorrect. A cash flow hedge is a type of derivative intended to hedge the exposure to variable cash flows of a forecasted transaction. However, cash flow hedges are one type of derivative, so other derivatives would not have such a specialized use.]

   c. Converting variable interest rates to fixed interest rates. [This answer is incorrect. An interest rate swap is a type of derivative that may be used to convert a variable interest rate to a fixed rate or vice versa. However, this is not the purpose of all derivatives.]

   d. Helping smaller entities manage risk exposure and speculate on the market. [This answer is correct. Derivatives offer a way for small and medium-sized entities to manage their exposure to risks and to speculate on changes in market conditions. Common derivatives, often referred to as plain vanilla derivatives, are available through banks and other sources.]

10. Which of the following presentation and disclosure considerations applies to an entity's receivables? **(Page 52)**

    a. All potential losses that affect receivables need to be disclosed. [This answer is incorrect. Losses that are probable but cannot be reasonably estimated and losses that are reasonably possible should be disclosed. All potential losses, however, do not need to be disclosed in their entirety.]

    b. Amounts due from affiliates should be included in current assets. [This answer is incorrect. If the balance sheet is presented in classified format, amounts due from officers, employees, affiliates, and others should be included in current assets only if they are collectible in the ordinary course of business within a year. Therefore, if the amounts are not collectible in that time period or if the balance sheet is not classified, including them on the balance sheet would not be the correct presentation.]

    c. Deferred fees or costs should be included in the related receivable's carrying amount. [This answer is correct. The following amounts should be included in determining the carrying amount of the related receivables: (1) deferred fees or costs, (2) discount from imputing interest, and (3) unearned interest included in the face of recorded receivables.]

    d. The aggregate amount of gains/losses for financing provided to customers should be presented separately. [This answer is incorrect. If the entity provides short-term or long-term financing to customers for sales of goods and services, among other things, if balances have been factored and the conditions for sale accounting have been met, the aggregate amount of gains or losses should be presented separately in the financial statements or disclosed in the notes to the financial statements.]

11. Which of the following entities is most likely to disclose a valuation allowance for trade accounts receivable? **(Page 54)**

    a. Cardinal Frocks had credit sales only to a few customers that all have a history of prompt payments. [This answer is incorrect. If substantially all of a business's credit sales are to a small number of customers who have a history of paying promptly, management may determine that a valuation allowance is unnecessary.]

    b. Kalen Enterprises wrote off all its uncollected year-end balances before the financial statement date. [This answer is incorrect. If management considered subsequent collection results and wrote off all year-end balances that were not collected by the time the financial statements are issued, the business likely would not need to include a valuation allowance.]

    c. Historically, Lansing-Ivy has a volatile customer base that is associated with a large amount of collection losses. [This answer is correct. Depending on the facts and circumstances, management may conclude that a valuation allowance is unnecessary. One example of circumstances in which this might be the case is when an entity's customer base is relatively stable, management closely monitors the business's outstanding customer balances, collection losses have historically been immaterial, and management is not aware of any customer disputes or any financial difficulties. Based on the information disclosed about Lansing-Ivy in this scenario, the historical records of its customer base make it more likely to need to disclose a valuation allowance than the other businesses described in these scenarios.]

    d. The management of Major Pointe Sales closely monitors its outstanding customer balances and knows of no difficulties. [This answer is incorrect. If management is closely monitoring the balances and is not aware of any customer disputes or financial difficulties, it is less likely that the business will need to disclose a valuation allowance. However, all facts and circumstances should be considered.]

THE CONSOLIDATION OF VARIABLE INTEREST ENTITIES (VIEs)

This section provides guidance on considering the need to include in the financial statements of small and midsize nonpublic entities the consolidated financial results of entities considered to be variable interest entities. The guidance in this section is designed to provide an overview that falls within the scope of this lesson on financial statement form and presentation. *PPC's Guide to Related Parties (Including Variable Interest Entities)* provides detailed guidance on VIEs.

An Accounting Alternative for Common Related Party Leasing Arrangements

FASB ASC 810-10-15-17AB provides small and midsize nonpublic entities with a limited accounting alternative to the guidance in the Variable Interest Entities Subsections (VIE Subsections) of FASB ASC 810-10.

An Overview of the Accounting Alternative. The accounting alternative is narrow, providing only an optional exemption of a defined related party leasing arrangement from the scope of the VIE Subsections. The accounting alternative is available for a related party leasing arrangement with the following characteristics:

a. The reporting entity is a nonpublic entity that leases property from an entity that is under common control with the reporting entity.

b. Substantially all activities between the reporting entity and the lessor entity relate to leasing activities, including activities that support the leasing activities, between the two entities.

c. If the reporting entity explicitly guarantees or provides collateral for any lessor obligation related to the asset being leased, the principal amount of the obligation does not exceed the value of the leased asset as of the inception date of the collateral arrangement or guarantee.

The VIE Subsections provide a list of relationships that generally indicate a variable interest entity relationship exists. If the relationships (discussed later in this lesson) do not exist, the guidance does not need to be considered. Additionally, with the accounting alternative, even if one or more of those relationships do exist, the VIE guidance does not need to be considered for a relationship that has the characteristics listed in the previous paragraph. For example, if the lessor entity was formed by the reporting entity and its related parties, consideration of the VIE guidance is not required if the relationship between the reporting entity and the lessor entity has the characteristics listed in the previous paragraph.

If a reporting entity satisfies the characteristics listed above and elects the accounting alternative, the reporting entity should apply the accounting alternative to all leasing arrangements that meet the conditions. If the reporting entity elects the accounting alternative, certain disclosures are required. The accounting alternative should be applied retrospectively as of the beginning of the fiscal year in which the election was made and to all periods presented. It is not necessary to justify that the accounting alternative is preferable.

Deciding Whether to Elect the Accounting Alternative. Electing the accounting alternative eliminates the need to consider whether consolidation is required under the VIE Subsections. In addition, electing the alternative requires only modest additional disclosures. It seems likely then, that the alternative will ordinarily be elected whenever the reporting entity has a relationship with the appropriate characteristics and consolidation of the related entities does not provide useful information to financial statement users. However, the alternative is available only for relationships with the specified characteristics and, therefore, does not eliminate the need for small and midsize nonpublic entities to consider whether the VIE Subsections apply in other situations. The remaining paragraphs discuss how to follow the guidance in the VIE Subsections for considering whether a VIE relationship exists.

When to Consider Whether the Reporting Entity Has a Variable Interest in a Variable Interest Entity

A small or midsize nonpublic entity should consider whether it has a variable interest in a variable interest entity if it has one of the following relationships with another entity (FASB ASC 810-10-15-12):

a. the reporting entity, its related parties, or both participated significantly in the design or redesign of the entity;

b. the entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties;

c. the reporting entity and its related parties provide more than half of the entity's subordinated financial support; or

d. the activities of the entity are primarily related to securitizations or other forms or asset-backed financings or single-lessee leasing arrangements.

Many small and midsize nonpublic entities have the first type of relationship with another entity. Typically, an individual has the majority voting equity interest in both the reporting entity and the other entity. However, the reporting entity may hold a majority or minority voting equity interest in the other entity. As a practical matter, a small or midsize nonpublic entity that has an investment in another small or midsize nonpublic entity is likely to have the first type of relationship with the investee. Examples of the first type of relationship with another small or midsize nonpublic entity are—

a. The holder of a majority voting equity interest in an operating entity may form a separate entity to acquire real estate to lease to the operating entity.

b. The holder of a majority voting equity interest in a homebuilder may form a separate entity to acquire and develop residential lots for sale to the homebuilder.

c. The holder of a majority voting equity interest in several dealerships may form a separate entity to perform senior management functions for the dealerships and centralize their marketing efforts.

d. A dealership and its key employees may be the members of a limited liability company they formed to provide financing for vehicle sales to individuals with higher-than-normal credit risk.

e. A computer manufacturer may form a corporation with two other equity investors to develop and market a new high-speed computer designed for gaming enthusiasts.

f. A real estate developer may form a limited liability company with a real estate broker to make speculative investments in undeveloped land.

A relationship that requires the reporting entity to consider whether it has a variable interest in a variable interest entity does *not* by itself mean that the reporting entity is required to include the consolidated financial results of the entity in its financial statements. A number of other considerations must be made before the reporting entity can decide whether consolidation is required.

Some reporting entities that are subject to specialized accounting guidance do not need to consider GAAP for VIEs. A reporting entity that is organized as a nonstock corporation and considered to be a not-for-profit entity under GAAP is exempt from GAAP for VIEs. However, if a not-for-profit entity is a related party of the reporting entity, the not-for-profit entity should be considered in determining whether the reporting entity or one of its related parties is most closely associated with a variable interest entity for purposes of determining the primary beneficiary.

A reporting entity also does not need to consider including in its financial statements the consolidated financial results of some types of entities. A reporting entity does not need to consider whether an employee benefit plan is a variable interest entity. In addition, a reporting entity would generally not need to consider whether a not-for-profit entity is a variable interest entity unless the reporting entity uses a not-for-profit entity in a manner similar to a variable interest entity. It seems likely that small and midsize nonpublic entities will rarely use a not-for-profit entity in that manner. Any not-for-profit entity with which they have a relationship is likely a charitable organization, and the measurement requirements of GAAP for VIEs would not apply to the relationship.

A reporting entity should not consolidate the financial results of a governmental organization. It should also not consolidate the financial results of a financing entity established by a governmental organization unless the financing entity is not a governmental organization and it is used by the reporting entity in a manner similar to a variable interest entity. It seems likely that small and midsize nonpublic entities will rarely be affected by this exemption. Other types of entities that should not be consolidated include investments accounted for at fair value following the specialized accounting guidance for investment companies and separate accounts of life insurance companies.

GAAP for VIEs also provides a partial exemption from its requirements for a reporting entity that has an interest in another entity created before December 31, 2003, if *after making an exhaustive effort* the reporting entity is unable to obtain the information necessary to (a) determine whether the entity in which it has the interest is a variable interest entity, (b) determine whether it is the primary beneficiary, or (c) gather the information necessary to consolidate the entity's financial results. However, certain disclosures are required, and the exemption only applies as long as the reporting entity is unable to gather the necessary information. It seems unlikely that this exemption will often apply to small and midsize nonpublic entities.

Some Notions Underlying the Remaining Considerations

The Notions of Losses, Benefits, and Sufficiency of Equity. Although the authoritative consolidation accounting literature does not define *controlling financial interest*, it establishes the presumption that a majority voting equity interest in an entity gives the holder a controlling financial interest in the entity. It also specifically acknowledges the possibility that the presumption may be overcome. The authoritative literature on accounting for a variable interest in a variable interest entity looks at an instance in which that presumption may be overcome.

To provide a conceptual framework for the guidance, the FASB established the notion that the determination of who has a controlling financial interest in another entity depends partly on who bears the risk of things going worse than expected and who reaps the benefits of things going better than expected. Said another way, who bears the risk or reaps the benefits of *variability* from expected results? Different terms are used to refer to variability:

a. The effect of things going worse than expected is generally referred to as either *losses* or *expected losses*. These two terms seem to differ only in how the risk of things going worse than expected is assessed. *Expected losses* are the result of a quantitative assessment, and *losses* are the result of a qualitative assessment. It is a best practice for the determination of whether a party bears the risk of things going worse than expected to always be based on a *qualitative* assessment, and, therefore, to refer to that risk as the risk of *losses*.

b. The effect of things going better than expected is generally referred to as either *benefits* or *expected residual returns*. *Expected residual returns* are the result of a quantitative assessment, and *benefits* are the result of a qualitative assessment. It is a best practice for the determination of whether a party has the rights to the benefits of things going better than expected to always be based on a *qualitative* assessment, and therefore refer to the effect of things going better than expected as *benefits*.

The notion of losses and benefits is therefore not the same as measures of operating performance such as results of operations or cash flows from operating activities. Instead, the notions of losses and benefits look at who assumes the risks and receives the rewards of variability from expected results.

Variability is always possible; therefore, probability is not relevant to qualitative assessments of the risk of losses and right to receive benefits. For example, a rental real estate entity may attempt to pass risk of property damage to insurers, but there is still the possibility damage may occur that is not covered by the carrier or for which a claim is denied.

The authoritative literature on accounting for a variable interest in a variable interest entity only specifically mentions *significance* of losses and benefits in the determination of whether a party holds a controlling financial interest in a variable interest entity. In that context, the guidance requires consideration of losses and benefits that could *potentially* be significant to the variable interest entity. Therefore, the determination is not made based on conditions that exist at the time the entity is formed but instead is made based on the assumption that future losses and benefits would be significant.

To illustrate, a limited liability company is formed to buy a tract of undeveloped land in a speculative area. The members' initial equity investment is 10% of the purchase price of the tract, and the entity finances 90% of the purchase price of the tract through nonrecourse financing. At the date of formation of the entity, the members' exposure to loss is their equity investment.

The equity investors' risk of loss may be limited by certain arrangements. For example, if a rental entity required the lessee to guarantee that the leased property would have a minimum value at the end of the lease, the equity investors are protected from the risk of losses from a decline in the fair value of the property.

In this set of facts and circumstances, the lessee bears the risk of losses that would be significant to the entity. If the appreciation in the fair value of the property is greater than the amount that would trigger exercise of the lessee's guarantee, the lessee would have no loss and the equity investors would receive all the benefits of the property's fair value appreciating more than expected.

Suppose that, instead of a guarantee of a minimum value, the lessee was given the option of purchasing the property at a prescribed amount at the end of the lease.

a. If appreciation was less than the expected amount, the lessee would not exercise the purchase option. The equity investors would therefore absorb the loss.

b. If appreciation was greater than the expected amount, the lessee would exercise the purchase option. The lessee would therefore receive the benefit.

In this set of facts and circumstances, the equity investors would have the risk of losses, but the lessee would have the right to benefits.

Assessing the Sufficiency of Equity. The notion of the sufficiency of the equity investment looks at who bears the risk of losses.

a. If the equity investors alone bear the risk of things going worse than expected—the risk of losses— equity is sufficient.

b. If other parties share that risk, equity is not sufficient.

Whether equity is sufficient to finance the entity's activities *without additional subordinated financial support* depends on whether the equity investors alone bear the risk of loss or whether others share that risk. If other parties share that risk, they are considered to be providing *additional subordinated financial support* through their variable interests. Determination of whether financial support is subordinated looks at the substance of the financial support rather than its form. For example, depending on the facts and circumstances, a subordinated note may or may not be *additional subordinated financial support*.

Whether equity is sufficient depends on the facts and circumstances, and it is a best practice to make this assessment qualitatively. Examples follow for an entity that is formed through debt and equity.

a. If the debt is payable to a bank and is at a level customary for commercial lending arrangements, the entity's equity is likely to be sufficient.

b. However, if the debt is payable to a venture capitalist and is at a level that exceeds the maximum under commercial lending arrangements, equity may be insufficient. For example, funding for a major unforeseen loss could likely come only through either subordinated financing or additional equity.

The Power to Direct Significant Activities. FASB ASC 810-10 introduced the notion of having the power to direct the activities of a variable interest entity that most significantly impact its economic performance. This notion requires identifying—

a. the goals in forming the entity,

b. the activities that are most important to ensuring that the entity meets those goals, and

c. the party that in substance controls those activities.

FASB ASC 810 does not define *economic performance*. However, it seems logical that how an entity's economic performance is viewed depends on the reasons it was formed. While the determination of economic performance therefore depends entirely on the facts and circumstances, an example follows using facts and circumstances common for many small and midsize nonpublic entities.

An individual owns half of the voting equity interest in an operating entity. The remaining half is owned primarily by five employees. Even though the individual does not have a majority voting equity interest, she in substance controls the entity, primarily because of her importance to the entity and her close relationship with three of the five employees. She decides to form a separate entity to acquire real estate and lease it to the operating entity. (Since the leasing entity and the operating entity are not commonly controlled, the accounting alternative for certain related party leasing arrangements that is provided by FASB ASC 810-10-15-17AB is not available.) The rental entity financed 80% of the cost of acquiring the property. The individual's primary financial goals in acquiring the property through a separate entity rather than through the operating entity were to give her a direct stream of cash flows through rentals and through the ultimate sale of the property.

The individual believed that the fair value of the property was likely to appreciate significantly because of changes happening in the geographical area around the property. As the fair value of the property appreciated, the fair market rentals would increase. Until the financing was settled, a significant portion of the rentals would be used for debt service, but in substance those payments would increase her investment in the property. Once the financing was settled, all of the rentals would in substance be a return on her investment. Sale of the property would provide her return of her investment plus an additional return on her investment from appreciation in the property's fair value.

In this set of facts and circumstances, the economic performance of the entity depends on the amount of cash flows it provides from renting the property and the amount of cash it provides from selling the property. It is the individual who has the power to direct the generation of rental cash flows and to direct the timing and manner of sale of the property. That conclusion also is not affected by whether the leasing entity engages a property manager or a real estate broker. Hiring those positions only delegates the power. That conclusion is not affected by the individual who holds the majority voting equity interest in the lessor also holding the majority voting equity interest in the lessee. Any decision made by the leasing entity is effectively made by the individual as the majority voting equity investor of the leasing entity, not in his or her capacity as majority voting equity investor in the lessee.

Determining Whether the Other Entity is a Variable Interest Entity

Once the reporting entity determines that it has a relationship that requires it to consider the authoritative literature on accounting for a variable interest in a variable interest entity, the next step is to consider whether the entity with which the reporting entity has the relationship is a variable interest entity. Generally, an entity is considered to be a variable interest entity if *either* of the following conditions is met:

a. Its equity is not sufficient to finance the entity's activities without additional subordinated financial support, or

b. Its equity investors do not have—

   (1) the power to direct the activities of the entity that most significantly impact its economic performance,

   (2) the obligation to absorb the entity's losses, or

   (3) the right to receive its benefits.

This definition effectively states that, for an entity to *not* be considered a variable interest entity, its equity investors must—

a. have enough equity investment at risk that the entity will be able to stand on its own,

b. have the power to direct the activities of the entity that most significantly impact its economic performance,

c. bear the risk of the entity's losses, *and*

d. have the right to receive the entity's benefits.

The underlying notion is that four things should ordinarily line up for a party that has a controlling financial interest in an entity: the amount at risk, the power to direct significant activities, the risk of losses, and the right to benefits. If they do not line up for the equity investors, there is the *presumption* that if there is a controlling financial interest, it is held by a party that does not hold a majority voting equity interest.

The determination of whether the entity is a variable interest entity is only relevant to determining whether the *reporting entity* should include the consolidated financial results of the entity in its financial statements, *even if* the reporting entity does not hold a majority voting equity interest in the entity. As a practical matter, however, even if the reporting entity has a relationship with an entity considered to be a variable interest entity, the reporting entity may not be required to include in its financial statements the consolidated financial results of the entity.

For example, the equity investors of a small or midsize nonpublic reporting entity may form an entity with a minimal amount of capital and plan to contribute additional capital when it is needed, sometimes referred to as a *capital call*. Similarly, they may form an entity with a minimal amount of capital and long-term debt either with a conversion feature or a plan to convert the debt to capital when it is needed. In each of those situations, the equity investors likely have the power to direct the entity's activities, the risk of its losses, and the right to its benefits.

The entity would nevertheless be considered a variable interest entity. However, the remaining considerations required by the authoritative literature on accounting for a variable interest in a variable interest entity may lead to the conclusion that the *reporting entity* does *not* have a controlling financial interest. Even if the reporting entity is not required to consolidate the VIE, the reporting entity must include certain disclosures in its financial statements if it has variable interests in the VIE.

Determining Whether the Reporting Entity Has a Variable Interest in a Variable Interest Entity

If the reporting entity determines that the entity with which it has one of the prescribed relationships listed earlier in this lesson is a variable interest entity, it must determine whether it has a variable interest in that entity. The determination that the entity is a variable interest entity establishes the presumption that if there is a controlling financial interest in the entity, it will be established through a *variable interest*.

A *variable interest* in a variable interest entity is a contractual, ownership, or other pecuniary interest in the entity that changes with fluctuations in the fair value of the entity's net assets. Whether a financial instrument is considered to be a variable interest is only relevant to the variable interest entity considerations, not for consideration of other GAAP requirements.

If the reporting entity has a majority voting equity interest in an entity, it may be required to consider both the general consolidation requirements of the authoritative consolidation accounting literature and the requirements in the authoritative literature on accounting for a variable interest in a variable interest entity. Holding an equity interest in an entity the reporting entity formed is one of the relationships that requires the reporting entity to consider the guidance in the authoritative literature on accounting for a variable interest in a variable interest entity. Holding an equity interest also gives the reporting entity a variable interest in the other entity. The reporting entity must therefore determine whether the entity is a variable interest entity.

a. If the entity is determined to be a variable interest entity, the reporting entity would consider the remaining requirements of the authoritative literature on accounting for a variable interest in a variable interest entity to determine whether it is required to include in its financial statements the consolidated financial results of the entity. If the remaining considerations in the authoritative literature on accounting for a variable interest in a variable interest entity lead the reporting entity to conclude that consolidation is not required, the reporting entity is not required to then consider the general requirements of the authoritative consolidation accounting literature.

b. If the entity is determined to not be a variable interest entity, the reporting entity would not make the remaining considerations of the authoritative literature on accounting for a variable interest in a variable interest entity. However, it would then need to consider whether consolidation was required under the general consolidation requirements of GAAP.

Whether a majority voting equity interest in an entity that is not a variable interest entity gives its holder a controlling financial interest requires judgment. As a practical matter, the considerations for determining whether consolidation of a variable interest entity is required will be helpful for making that determination.

The definition of a variable interest as a *pecuniary interest* means that a variable interest may be explicit or implicit. Generally, an explicit variable interest arises from a financial instrument, and an implicit variable interest arises from a relationship.

Determining Whether Consolidation is Required

If the reporting entity determines that it has a variable interest in a variable interest entity, it must then determine whether it is required to include the consolidated financial results of the entity in its financial statements. The party that has a controlling financial interest in a variable interest entity is considered to be its *primary beneficiary*; however—

a. An individual may be the primary beneficiary.

b. Not all variable interest entities have a primary beneficiary, just as not all entities that are not variable interest entities have a controlling financial interest. For example, all of the equity investment in an entity that is not a variable interest entity may be held by two individuals who have equal voting interests. Similarly, two holders of variable interests in a variable interest entity may share the obligation for the losses of the entity and the right to its benefits.

c. If a VIE does not have a primary beneficiary, only one entity is expected to be identified as the primary beneficiary. In other words, a VIE would not be expected to have more than one primary beneficiary.

To be considered the primary beneficiary of a variable interest entity, an individual or entity must have a variable interest in the variable interest entity and have *both* of the following characteristics:

a. The power to direct the activities of the variable interest entity that most significantly impact the economic performance of the variable interest entity, and

b. *Either* the obligation to absorb losses of the variable interest entity that could potentially be significant *to the variable interest entity* or the right to receive benefits from the variable interest entity that could potentially be significant *to the variable interest entity*.

The determination of whether the reporting entity is the primary beneficiary of the variable interest entity may require the reporting entity to consider related-party relationships as well. The reporting entity should first determine whether it has both of the characteristics of a primary beneficiary. If it has both characteristics, the reporting entity should include the consolidated financial results of the variable interest entity in its financial statements.

If the reporting entity lacks one or both characteristics, it should determine whether one of its related parties has both characteristics. If a related party has both characteristics of a primary beneficiary, the reporting entity should not include the consolidated financial results of the variable interest entity in its financial statements.

For example, if the reporting entity is able to determine that the majority voting equity investor of the variable interest entity has the power to direct activities that most significantly impact the entity's economic performance and has the right to receive the entity's benefits, that individual would be considered to be the primary beneficiary of the variable interest entity. The reporting entity would therefore not need to consider the remaining measurement provisions of the authoritative literature on accounting for a variable interest in a variable interest entity.

This does not mean that the individual would have to include in his financial statements the consolidated financial results of the entity. It only means that the reporting entity does not need to include in its financial statements the consolidated financial results of the variable interest entity. Generally accepted accounting principles for personal financial statements do not permit consolidation.

If a related party does not have both characteristics of a primary beneficiary, the reporting entity should determine whether the reporting entity and its related parties as a group have both characteristics of a primary beneficiary. If the group does not have both of those characteristics, the reporting entity should not include the consolidated financial results of the variable interest entity in its financial statements.

However, if the group has both characteristics, the reporting entity should determine whether it is the member of the group most closely associated with the variable interest entity. If the reporting entity is the most closely associated party, it should include the consolidated financial results of the variable interest entity in its financial statements. If it is not the most closely associated party, the reporting entity should not include the consolidated financial results of the variable interest entity in its financial statements.

The determination of whether the reporting entity is the party in the related-party group most closely associated with the variable interest entity should be made based on assessments of all relevant facts and circumstances, including—

a. whether there is a principal-agency relationship between members of the related-party group,

b. the relationship and significance of the activities of the variable interest entity to members of the related-party group,

c. the exposure of members to the variability associated with the anticipated economic performance of the variable interest entity, and

d. the design of the variable interest entity.

The following paragraphs discuss the assessments to determine the party most closely associated with a variable interest entity in the context of an operating entity that has a variable interest in a real estate rental entity that is a variable interest entity and leases its property to the operating entity. The lessee is the reporting entity, and one individual holds all the equity of the lessor and the lessee. However, the accounting alternative offered by FASB ASC 810-10-15-17AB for certain related party leasing arrangements is not available because, in addition to leasing property to the operating entity, the leasing entity also operates a wholesale distribution business and sells products to the operating entity.

Is There a Principal-agency Relationship between Members of the Related-party Group? The existence of a principal-agency relationship provides evidence that the principal is more closely associated with the lessor than the agent. For example, a related-party group consists of a lessee and an individual who owns all its equity. If the lessee can make no major decisions apart from the individual, there is a principal-agency relationship between the individual and the lessee, with the individual being the principal in the relationship. That provides evidence that the individual, rather than the lessee, is the party in the related-party group most closely associated with the lessor.

Are the Activities of the Lessor More Important to One Member of the Related-party Group Than to Another? A determination that the activities of the lessor are more important to one member of the related-party group provides evidence that this member is more closely associated with the lessor than other members. However, depending on the facts and circumstances, the activities of the lessor may be equally important to the members of the related-party group.

For example, a related-party group consists of a lessee and an individual who owns all the equity of the lessee and the lessor is important to the individual as a source of cash flows to fund retirement. If nothing is unusual about the features of the real estate or its location, such that changing locations would not be difficult, the activities of the lessor may be equally important to the individual and the lessee. In this set of facts and circumstances, the assessment provides no evidence as to whether the lessee or the individual is more closely associated with the lessor.

Does One Party Have More Exposure to the Variability Associated with the Anticipated Economic Performance of the Variable Interest Entity? This assessment may be made qualitatively or quantitatively; however, a qualitative assessment is recommended by this course. For example, a related-party group consists of a lessee (whose sole variable interest in the lessor is an implicit variable interest through the related-party relationship) and a sole equity investor of the lessee (whose variable interests consist of the equity investment and a guarantee of the lessor's debt). The existence of the implicit variable interest may indicate that (a) the individual would use net assets of the lessee to subsidize losses of the lessor to avoid having the guarantee exercised and (b) the exposure of the lessee to losses of the lessor is therefore greater than the exposure of the individual. This would provide evidence that the lessee is more closely associated with the lessor than the individual.

What Is the Design of the Lessor? The typical related-party leasing arrangement is designed to give the individual control of the property, which provides evidence that the individual is more closely associated with the lessor than the lessee is.

Evaluating the Results. Rather than viewing the assessments as a scorecard, the results of the four assessments should be evaluated together. Depending on the facts and circumstances, one of the assessments may be viewed as providing more persuasive evidence of which party is most closely associated than the other assessments. For example, in some situations, the design of the lessor to give the individual control of the property may be viewed as providing more persuasive evidence, while in other situations special characteristics of the real estate or its location may provide more persuasive evidence.

Disclosures. The authoritative literature on accounting for a variable interest in a variable interest entity requires certain disclosures when consolidation is required. It also requires certain disclosures if consolidation is not required. For example, if the owner of the lessee is considered to be the most closely associated (rather than the lessee), the lessee would not be required to include the financial results of the lessor in its consolidated financial statements but would be required to provide certain disclosures, generally about the effects of the lessee's variable interest in the lessor.

ASU 2015-02 Revisions to Consolidations

ASU 2015-02, *Consolidation (Topic 810: Amendments to the Consolidation Analysis,* addresses situations where extant GAAP may call for the consolidation of a legal entity when the reporting entity does not hold a majority of the voting rights of the legal entity. In other cases, consolidation may be required even though the reporting entity's contractual rights do not give it the ability to act primarily on its own behalf or the reporting entity is not exposed to the majority of the economic benefits or obligations of the legal entity.

The amendments to FASB ASC 810 affect any reporting entity that is required to evaluate whether it needs to consolidate certain legal entities. The ASU specifically:

- Eliminates the presumption that a general partner should consolidate a limited partnership.

- Modifies the evaluation of whether limited partnerships and similar legal entities are variable interest entities (VIEs) or voting interest entities.

- Impacts the consolidation analysis for reporting entities that have involvement with VIEs, especially if they have fee arrangements and related-party relationships.

- Provides a scope exception to the consolidation standard for reporting entities with interests in legal entities that need to comply with Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds (or similar requirements).

For nonpublic entities, the ASU is effective for fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017. Early adoption is allowed, including adoption in an interim period. The ASU may be applied using either a modified retrospective approach or retrospectively. It does not seem likely that the ASU will affect small and midsize nonpublic entities, so it generally does not affect the guidance in this section. *PPC's Guide to Related Parties (Including Variable Interest Entities)* contains a detailed analysis of this ASU.

After the issuance of ASU 2015-02, the FASB added two projects to its technical agenda related to consolidation. The first project provides additional guidance in certain situations involving entities under common control when determining whether a reporting entity is the primary beneficiary of a VIE. ASU 2015-02 requires a single decision maker of a VIE, in circumstances involving common control, to attribute interests held by certain of its related parties entirely to itself, which may require it to consolidate a VIE even if it has little to no variable interests in the VIE.

In October 2016, the FASB issued ASU 2016-17, *Consolidation (Topic 810): Interests Held through Related Parties That Are under Common Control*. ASU 2016-17 does not change the characteristics of a primary beneficiary under current GAAP. However, the amendments require that a reporting entity, that is a single decision maker of a VIE, include all of its direct variable interests in a VIE and, on a proportionate basis, its indirect variable interests in a VIE held through related parties, including related parties that are under common control with the reporting entity, in determining whether the reporting entity is the primary beneficiary of the VIE. ASU 2016-07 has the same effective date as ASU 2015-02.

The second project was needed to clarify when a nonprofit organization that is a general partner or a limited partner should consolidate a for-profit limited partnership or similar entity. ASU 2015-02 eliminated the guidance in FASB ASC 810-20 that addresses consolidation by general partners that are excluded from the VIE subsections of FASB ASC 810-10. In January 2017, the FASB issued ASU 2017-02, *Not-for-Profit Entities—Consolidation (Subtopic 958-810): Clarifying When a Not-for-Profit Entity That Is a General Partner or a Limited Partner Should Consolidate a For-Profit Limited Partnership or Similar Entity*. ASU 2017-02 generally maintains the current practice for consolidation by nonprofit organizations that are general partners. ASU 2017-02 has the same effective date as ASU 2015-02; thus, nonprofit organizations that are general partners would continue to apply the current guidance for reporting their limited partnership interests and would not be required to apply the amendments included in ASU 2015-02.

UNCERTAINTIES REGARDING AN ENTITY'S TAX POSITIONS

Accounting for Uncertainty in Income Taxes

FASB ASC 740-10, *Income Taxes*, prescribes measurement and disclosure requirements for current and deferred income tax provisions.

Generally, FASB ASC 740-10 permits recognizing current and deferred income tax benefits only if it is more likely than not that the reporting entity's tax treatment would be sustained in the event of an examination by taxing authorities. FASB ASC 740-10 requires that determination to be made by establishing various probability scenarios and recognizing the largest benefit that has a greater than 50% chance of being sustained.

Depending on the facts and circumstances, assessing the likelihood that a position will be sustained may be relatively straightforward. The reporting entity is only required to consider whether there is a greater than 50% chance the position will be sustained. As a practical matter, the tax positions of many small and midsize nonissuers are likely to be based on clear and unambiguous tax law and, thus, have a far greater than 50% chance of being sustained upon examination.

To illustrate the application of FASB ASC 740-10, assume that the reporting entity—

a. is subject to federal income taxes but not state income taxes;

b. has no temporary differences;

c. reports taxable income of $60, consisting of revenue of $100 and expense of $40;

d. reports tax of $24 in its tax return, computed by applying the 40% tax rate to taxable income of $60; and

e. believes that the $40 expense was incurred in a routine business transaction and that its deductibility is supported by clear and unambiguous tax law.

There is, therefore, a high probability that the deductibility of the expense would be sustained upon examination by the IRS. Under FASB ASC 740-10, the reporting entity would recognize income tax expense of $24, which is the amount of taxes reported in the income tax return.

However, if the last assumption in the preceding paragraph is changed so that the $40 expense was incurred in an unusual arrangement and, while research supports the deductibility of the expense, there is a risk that the IRS would deny the deduction under examination. FASB ASC 740-10 requires the reporting entity to assume that the tax return in which the deduction is taken will be examined, and that the IRS will focus on the deduction. The reporting entity believes that there is at best a 50% chance that the deduction would be sustained under examination. Under FASB ASC 740-10, the reporting entity would recognize income tax expense of $40, computed by applying the 40% tax rate to revenue of $100.

FASB ASC 740-10 would not permit the reporting entity to recognize any of the $16 tax benefit of the $40 expense since there is no more than a 50% chance that the deductibility of the expense would be sustained in an IRS examination. In addition, it would not permit recognizing a deferred tax benefit, even if a $16 valuation allowance was provided for the $16 deferred tax asset. However, FASB ASC 740-10 would require certain disclosures about the $16 unrecognized tax benefit.

FASB ASC 740-10 notes that interest and penalties related to income taxes may be presented in the financial statements with expenses that are included in the computation of income before income taxes, or they may be included in the tax provision. However, FASB ASC 740-10 requires the reporting entity to disclose its policy for presenting interest and penalties related to income taxes and to disclose their amounts.

FASB ASC 740-10 also requires disclosure of tax years that remain subject to examination by major tax jurisdictions. In March 2015, a nonauthoritative Q&A formerly included as Q&A 5250.15 was deleted. That Q&A had noted that a description of open tax years subject to examination should be provided regardless of whether the entity had uncertain tax positions. The Private Company Council and the FASB stated in a meeting in February 2015 that disclosures are necessary only if an entity has uncertain tax positions. As a result, the disclosure of open tax years is only required when an entity has significant tax positions that do not meet the more-likely-than-not criterion.

The following illustrates the disclosure FASB ASC 740-10 would require for the example entity discussed earlier in this section.

> The tax provision reported in the accompanying financial statements is greater than the income tax reported in the company's income tax return. The $16 excess is due to a reduction of income tax reported in the tax return for a deduction that might be disallowed if the IRS examines the tax return and interprets existing guidance differently from the Company's interpretation. The tax benefit from the deduction was not recognized in the financial statements. There is a reasonable possibility guidance will be provided within the next year that provides additional evidence about whether the deduction would be allowed upon examination.

The requirement of FASB ASC 740-10 to disclose the entity's policy for presenting interest and penalties related to income taxes can be provided in a variety of ways. For example, the disclosure could be provided in a policy note, such as, "Interest and penalties assessed by income taxing authorities are included in operating expenses." However, disclosure of interest and penalties as line items in the financial statements also discloses the entity's presentation policy.

The requirement to disclose the amounts of interest and penalties related to income taxes can be met by disclosing those amounts either in the financial statements themselves or in a note to the financial statements.

The following illustrates a disclosure of the tax years that remain subject to examination by major tax jurisdictions that is discussed above.

> The Company's federal income tax returns for 20X1, 20X2, and 20X3 are subject to examination by the IRS, generally for three years after they were filed.

FASB ASC 740-10 includes guidance for pass-through entities and not-for-profit organizations. Lesson 2 discusses the impact of FASB ASC 740-10 on partnerships and Lesson 3 discusses the impact of FASB ASC 740-10 on S corporations.

PPC's Guide to Accounting for Income Taxes discusses FASB ASC 740-10 in more detail.

DEALING WITH CONSOLIDATED, CONSOLIDATING, AND COMBINED FINANCIAL STATEMENTS

Consolidated and Consolidating Financial Statements

Consolidated financial statements combine a parent company's financial position and results of operations with those of its subsidiaries as if they were a single entity. Consolidating financial statements usually present the financial position and results of operations of the parent company and each of its subsidiaries in columnar form, together with columns that show eliminations of intercompany items and the consolidated totals.

Consolidating financial statements for a parent company and its two subsidiaries, for example, might be presented in the following format:

Column A—Parent company's financial statements

Column B—Subsidiary #1's financial statements

Column C—Subsidiary #2's financial statements

Column D—Consolidating entries

Column E—Consolidated totals

Consolidating financial statements contain all the columns A through E, but consolidated financial statements would include only the balances in column E.

The consolidating entries column (column D) includes essentially the same eliminating entries as those that would be entered on a worksheet for preparing consolidated financial statements.

The balances shown in columns A through C (i.e., the balances for the individual companies—the parent and each of the subsidiaries) should be adjusted balances that are in accordance with GAAP. For example, the balances in column B for subsidiary #1 should be the same adjusted balances as those that would be reported in separate financial statements for subsidiary #1. Similarly, the balances shown in column A for the parent company should be the adjusted balances that would be reported in parent company financial statements. That means, for example, that the carrying amount of the parent's investment account should be determined using the equity method of accounting. In addition, if a consolidated tax return is filed, the income tax expense listed for each company should be its allocated portion of the consolidated income tax. However, there is no need for the parent and the subsidiaries to enter these adjustments into their accounting systems.

Reporting Implications of Consolidating Financial Statements

When consolidating financial statements are presented, the consolidating amounts for each of the respective companies (columns A through C above) may be presented as part of the basic financial statements or only as additional information. In either case, the consolidated totals in column E are part of the basic financial statements.

If the consolidating amounts for each of the respective companies (columns A through C above) are presented as part of the basic financial statements, accountants would report on each company's financial statements that are included in the consolidated totals. In that case, accountants would report on columns A through C and E. Accordingly, the consolidating financial statements and accompanying notes must include all the disclosures that are necessary to present the separate financial statements of each company in conformity with generally accepted accounting principles.

If the consolidating amounts (columns A through C above) are presented as supplemental information only, accountants would report only on the consolidated financial statements, i.e., the amounts in column E, as basic financial statements. The consolidating information would be reported on as supplemental information that would not be considered necessary for the fair presentation of the consolidated financial statements in conformity with generally accepted accounting principles.

In consolidated financial statements, subsidiary details do not need to be disclosed. The principal underlying reason for that position is that the financial statements are those of the consolidated entity; therefore, it is the consolidated information, rather than the details of any of the combining companies, that is relevant. Of course, that general rule is not an absolute. There may be cases in which the disclosure of certain detailed information related to one of the combining companies might be necessary to make the financial statements sufficiently informative.

Combined Financial Statements

In some circumstances, combined financial statements may be useful or even necessary. FASB ASC 810-10-55-1B states: "There are circumstances, however, where combined financial statements (as distinguished from consolidated financial statements) of commonly controlled companies are likely to be more meaningful than their separate financial statements." The guidance goes on to indicate that it might be more meaningful to use combined financial statements for (a) two or more companies that are related in their operations and are controlled by the same individual, (b) a group of unconsolidated subsidiaries, or (c) companies under common management.

Many nonissuers have common controlling interests, and it is often difficult for accountants to decide whether combined financial statements are more meaningful than separate statements in those circumstances. In addition, clients may resist presenting combined financial statements in some cases. For example:

a. A developer may only want financial statements for a company requesting a bank loan. Tax returns may provide sufficient information for the other companies controlled by the developer.

b. An individual may use different accountants for some entities and may not want to incur the additional fees of combining their financial statements.

c. An individual may not want a user of the financial statements to be provided with financial information about companies that do not affect the user, such as a bank whose loan is secured by the assets of a single entity.

It is difficult for accountants to require clients to present combined financial statements because the wording of FASB ASC 810-10-55-1B is soft in that respect. Some accountants believe GAAP does in fact require combined financial statements when it is determined that combined statements would be more meaningful. Other accountants believe that GAAP is so soft that it does not require combined financial statements even when it is determined that combined statements would be more meaningful. It is a best practice for accountants to consider whether combined financial statements are likely to be more meaningful than separate statements. That assessment will depend on the facts and circumstances of each engagement. Some clients prefer combined financial statements after accountants have explained their benefits. When an accountant concludes that financial statements should be combined and the client refuses, it is a best practice for the accountants to modify their report for a departure from GAAP. As a practical matter, such a report modification may be acceptable both to the client and to other users of the financial statements.

The procedures that apply to preparing combined financial statements are similar to those that apply to preparing consolidated financial statements. Intercompany transactions and profits and losses should be eliminated in preparing combined financial statements as they would be in preparing consolidated financial statements. Minority interests, foreign operations, differences resulting from different fiscal periods, and income taxes also should be treated in the same manner as in consolidated financial statements.

The principal difference between consolidated and combined financial statements is that because none of the companies included in combined financial statements has an investment in the common stock of the other companies, the equity accounts of the various companies are combined rather than offset against the investment in subsidiaries held by the parent company.

Unfortunately, GAAP does not state how to present the stockholders' equity section of a combined balance sheet. However, an AICPA technical question and answer at Q&A 1400.06 provides limited guidance. It indicates that appropriate disclosure depends on the circumstances. It further suggests that the number of shares of stock that are authorized and outstanding, and the par value of those shares for each company, should be disclosed either on the face of the balance sheet or in the notes.

Combined financial statements are not limited to particular forms of entities. The following are two principal prerequisites for preparing combined financial statements:

a. The entities are under common control.

b. Combined financial statements are more meaningful than separate statements.

Combined financial statements are appropriate, for example, in the case of an individual who owns a controlling interest in each of three separate corporations. Similarly, combined statements are appropriate in the case of an individual who is the majority partner in each of two different partnerships. Combined financial statements also are appropriate for the combination of a partnership and a corporation that are commonly owned.

Combined Financial Statement Style and Format Considerations

Combined financial statements are similar to consolidated financial statements in that they present financial position, results of operations, and cash flows of an "economic" rather than a "legal" entity. Accordingly, the name in the heading of the financial statements should indicate the nature of the economic entity, such as ABC Corporation and Affiliates.

Equity Section. As mentioned previously, GAAP are not explicit about the appropriate presentation of the owners' equity section of a combined balance sheet. Appropriate disclosure, therefore, will depend on the particular circumstances. The owners' equity section of a combined balance sheet for ABC Corporation and XYZ Company, two companies under common control, could be presented in any of the following ways:

STOCKHOLDERS' EQUITY		
Common stock	$	50,000
Retained earnings		60,000
		110,000

or

STOCKHOLDERS' EQUITY		
Common stock		
ABC Corporation	$	30,000
XYZ Company		20,000
		50,000
Retained earnings		60,000
		110,000

or

STOCKHOLDERS' EQUITY		
Common stock		
ABC Corporation	$	30,000
XYZ Company		20,000
		50,000
Retained earnings		
ABC Corporation		40,000
XYZ Company		20,000
		60,000
		110,000

or

EQUITY		
Partners' capital	$	40,000
Stockholders' equity		
Common stock		30,000
Retained earnings		40,000
		70,000
		110,000

The components of equity also could be disclosed in a note.

An AICPA technical question and answer at Q&A 1400.06 points out that, in some circumstances, it may not be necessary to disclose how retained earnings are allocated between the companies, while in other situations such disclosure would be required. For example, it may be necessary to disclose how retained earnings are allocated between the companies if the losses of either company have been so severe that an insolvent condition might be anticipated.

Accounting for Intangible Assets in a Business Combination

FASB ASC 805-20 provides an accounting alternative to simplify accounting for certain identifiable intangible assets acquired in business combinations by private companies. A private company that elects the accounting alternative to recognize or otherwise consider the fair value of intangible assets as a result of any business combinations should no longer recognize separately from goodwill (a) customer-related intangible assets unless they are capable of being sold or licensed independently from the other assets of the business and (b) noncompete agreements. Entities electing this accounting treatment would generally recognize fewer identifiable intangible assets than under current GAAP. An entity that makes this election must also elect the private company alternative to amortize goodwill as described in FASB ASC 350-20-35-62.

CONSIDERATIONS FOR FAIR VALUE MEASUREMENTS

The Definition of Fair Value

FASB ASC 820-10-20 defines *fair value* as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

The Assets or Liabilities

Fair value is measured for a particular asset or liability, which may be a standalone asset or liability, or a group of assets or liabilities. Attributes that are specific to the asset or liability, such as its condition or location and restrictions on its sale or use, should be considered when measuring fair value. Whether an asset or liability is measured on a standalone basis or as a group is determined by the provisions of the accounting pronouncement that requires or permits the asset or liability to be measured at fair value.

The Price

Fair value measurement assumes that an asset or liability is exchanged in an orderly transaction. That means the hypothetical transaction to sell the asset or transfer the liability is assumed to be usual and customary for the type of asset or liability and not a forced liquidation or distress sale. The transaction is considered from the perspective of the entity holding the asset or liability, with the objective of determining the price that would be received or paid to sell the asset or transfer the liability.

The Market

The determination of fair value assumes that the hypothetical sale or transfer of the asset or liability being valued occurs in its principal market. The *principal market* for an asset or liability is the market with the greatest volume or level of activity for the asset or liability. If there is no principal market, the transaction is assumed to occur in the *most advantageous market*, representing the market in which the reporting entity would maximize the amount received for the asset or minimize the amount paid to transfer the liability. When a principal market exists, fair value measurement should use the price in that market even if the price in another market is more advantageous at the measurement date. The price used to measure fair value should not be adjusted for transaction costs. (Costs to transport an asset or liability to or from its principal or most advantageous market are not transaction costs, however, and the market price *should* be adjusted for those costs.)

Market Participants

Fair value should be measured based on the assumptions market participants would use in pricing the asset or liability. *Market participants* are buyers and sellers in the principal or most advantageous market who are—

a. Independent of the reporting entity (i.e., not related parties).

b. Reasonably knowledgeable of the asset or liability and the transaction based on available information.

c. Able to conduct the transaction.

d. Willing to conduct the transaction.

Asset Valuation Considerations

When measuring the fair value of an asset, the highest and best use of the asset by market participants should be assumed. The highest and best use of an asset considers what is physically possible, legally permissible, and financially feasible at the measurement date. It represents the use that would maximize the value of the asset or group of assets within which the asset would be used, even if that use is different from the intended use by the reporting entity. The highest and best use of an asset may be—

a. *In use*. The asset provides maximum value to market participants when used in combination with other assets as a group. In that case, fair value is determined based on the price that would be received in a current transaction to sell the asset, assuming that it would be used with other assets as a group and the assets would be available to market participants.

b. *In exchange*. The asset provides maximum value to market participants primarily on a standalone basis. In that case, fair value is determined based on the price that would be received in a current transaction to sell the standalone asset, assuming that it would be used on a standalone basis.

Liability Valuation Considerations

When determining the fair value of a liability, it is assumed that the liability is transferred to a market participant on the measurement date rather than being settled with the counterparty. The risk that the liability will not be fulfilled, including the reporting entity's credit risk, is assumed to be the same both before and after the transfer. For all periods in which a liability is measured at fair value, the reporting entity should consider the effect of its credit risk on the fair value of the liability.

Although the fair value of a liability assumes an exchange in an orderly transaction between market participants, transfers of liabilities in the marketplace rarely occur due to contractual or legal restrictions. When available, a quoted price in an active market for the identical liability represents a Level 1 measurement. However, when a quoted price is not available, fair value for a liability should be measured using one or more of the following:

a. A valuation approach that uses the quoted price of the identical liability when traded as an asset or quoted prices for similar liabilities or similar liabilities when traded as assets.

b. Another valuation approach, such as a present value technique or a market approach.

Relevant observable inputs should be used to the maximum extent possible and the overall objective of fair value measurement for liabilities, as discussed earlier in this section, should be achieved.

When measuring fair value based on the quoted price of a liability when traded as an asset, the quoted price of the asset should not be adjusted for the effect of a restriction preventing its sale. However, the quoted price should be adjusted for factors specific to the asset that are not applicable to fair value measurement of the liability. (If adjustments to quoted prices are necessary, the measurement is no longer a Level 1 input.) Also, when estimating the fair value of a liability, no separate adjustment should be made for a restriction that prevents transfer of the liability.

Initial Recognition

Fair value measurement is based on an exit price. An *exit price* is the price that would be received to sell an asset or paid to transfer a liability. In contrast, an *entry price* is the transaction price that would be paid to acquire an asset or received to assume a liability. Those prices may be different because, for example, an asset might not be sold at the same price that would be paid to acquire it. Similarly, a liability might not be transferred at the same price received to assume it.

In many cases, the transaction or entry price will equal the exit price when an asset or liability is initially recognized. In those cases, the transaction price represents fair value. However, the following factors specific to the transaction might indicate that the transaction price does not represent the fair value of the asset or liability:

- The transaction occurs between related parties.
- The seller is forced to accept the price or conducts the transaction under duress.
- The transaction contains elements other than the asset or liability being measured. For example, the transaction might include unstated rights and privileges, or the transaction price might include transaction costs.
- The market for the transaction differs from the principal or most advantageous market where the asset would be sold or the liability transferred.

Valuation Techniques

In December 2016, the FASB issued ASU 2016-19, *Technical Corrections and Improvements*. The ASU clarifies the difference between a *valuation approach* and a *valuation technique* when applying the guidance in FASB ASC 820, *Fair Value Measurement*. Additionally, ASU 2016-19 requires an entity to disclose when there has been a change in valuation approach and/or a valuation technique for recurring and nonrecurring Level 2 and Level 3 fair value measurements. ASU 2016-19 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. Early application is permitted, subject to specific transition guidance in the ASU. The guidance in the ASU is required to be applied on a prospective basis.

Fair value should be measured using valuation techniques consistent with the following:

a. *Market Approach*. This approach uses prices or relevant information derived from market transactions for identical or comparable assets or liabilities (including businesses). Valuation techniques that are consistent with a market approach include techniques that use market multiples derived from a set of comparables and matrix pricing, which is primarily used to value debt securities.

b. *Income Approach*. This approach converts future amounts such as cash flows or earnings to a single current amount (i.e., discounted) based on current market expectations about those future amounts. Examples of valuation techniques consistent with the income approach include present value techniques, option-pricing models such as the Black-Scholes-Merton formula and a binomial model, and the multiperiod excess earnings method primarily used to measure the fair value of certain intangibles.

c. *Cost Approach*. This approach is based on the amount that currently would be required to replace the service capacity of an asset. The fair value of an asset using this approach is the cost to a market participant to acquire or construct a substitute asset of comparable utility adjusted for obsolescence.

When measuring fair value, an entity should use valuation techniques that are appropriate in the circumstances and for which sufficient data are available. Depending on the situation, a single technique or multiple techniques may be appropriate. For example, a single technique may be appropriate when quoted market prices exist in an active market for identical assets. Multiple techniques may be appropriate, however, when valuing a reporting unit. When multiple techniques are used, the results should be evaluated and weighted to determine a reasonable range of results. Fair value is the point within the range that is most representative in the circumstances.

Valuation techniques used to measure fair value should be consistently applied. However, an entity may change a valuation technique or its application if the resulting measurement is equally or more representative of fair value in the circumstances. This might occur if new information becomes available, information previously used is no longer available, new markets develop, or improvements in valuation techniques occur. Revisions that result from such changes should be accounted for as changes in accounting estimate. However, the disclosures for a change in accounting estimate are not required.

Valuation Inputs and the Fair Value Hierarchy

Inputs to valuation techniques represent the assumptions that would be used by market participants in pricing an asset or liability, including assumptions about risk. *Observable inputs* are assumptions based on market data obtained from sources independent of the reporting entity. In contrast, *unobservable inputs* are the reporting entity's own assumptions about what market participants would assume based on the best information available in the circumstances. Relevant observable inputs should be used to the maximum extent possible when determining fair value.

A fair value hierarchy is used to prioritize valuation inputs into three levels:

a. Level 1—quoted prices (unadjusted) in active markets for identical assets or liabilities.

b. Level 2—observable inputs other than the quoted prices included in Level 1.

c. Level 3—unobservable inputs.

The hierarchy only prioritizes the inputs, not the valuation techniques that are used. The inputs used in a given valuation may fall in different levels of the hierarchy. The level in the hierarchy in which the resulting fair value measurement falls is based on the lowest level input that is significant to the overall valuation, regardless of the valuation technique(s) used. Determining whether an input is significant is a judgmental matter requiring consideration of factors specific to the asset or liability.

Level 1 Inputs. A quoted price in an active market for an identical asset or liability (that is, a Level 1 input) is considered to be the most reliable evidence of fair value. Active markets are those in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis. Level 1 inputs should be used to measure fair value whenever they are available, except as discussed in the next paragraph.

In certain situations quoted prices may be available, but not used exclusively in measuring fair value. Such situations include—

a. The entity is required to measure a large number of similar assets or liabilities at fair value (for example, debt securities). Quoted prices might be available, but are not readily assessable for each of the individual assets or liabilities. In that case, as a practical expedient, fair value may be measured using an alternative method, such as matrix pricing, that does not exclusively use quoted prices.

b. A quoted price does not represent fair value at the measurement date. That could occur if a significant event occurs after the market close but prior to the measurement date. In such cases, the reporting entity is required to establish and consistently apply a policy for identifying those events that could impact fair value measurements. The quoted price may be adjusted for that new information.

The use of an alternative pricing method or quoted price adjusted for new information results in a fair value measurement that falls in a lower level of the fair value hierarchy.

When a single financial instrument is traded in an active market, fair value is the product of the quoted price times the quantity held by the reporting entity. The quoted price should not be adjusted for a blockage factor, even if the market's normal daily trading volume would not be sufficient to absorb the quantity held by the reporting entity in a single transaction without affecting the price.

Level 2 Inputs. Level 2 inputs are those that are observable, either directly or indirectly, for the asset or liability other than quoted prices included in Level 1. These inputs include—

a. Quoted prices for similar assets or liabilities in active markets.

b. Quoted prices for identical or similar assets or liabilities in markets that are not active.

c. Other observable inputs, such as interest rates and yield curves observable at commonly quoted intervals, volatilities, default rates, prepayment speeds, loss severities, and credit risks.

d. Other inputs that are primarily derived from or corroborated by observable market data.

Adjustments of Level 2 inputs will vary based on factors specific to the asset or liability, such as—

a. Condition or location of the asset or liability.

b. Volume and activity in the markets in which the inputs are observed.

c. Extent to which the inputs relate to items that are comparable to the asset or liability, including the factors discussed earlier in this section.

Level 3 Inputs. These inputs, which are unobservable, should be used for fair value measurement only when observable inputs are not available. Thus, these inputs apply when little or no market activity for the asset or liability occurs at the measurement date, and may include the reporting entity's own data. As noted previously, Level 3 inputs should be developed based on the best information available in the circumstances. An entity does not need to undertake an exhaustive effort to obtain information about market participant assumptions, but should use information that is reasonably available without undue cost and effort.

Bid and Ask Prices. Regardless of where the input falls in the fair value hierarchy (Level 1, 2, or 3), an entity using a bid and ask price to measure fair value should use the price within the bid-ask spread that is most representative of fair value in the circumstances. Using bid prices for assets and ask prices for liabilities is permitted but not required. Mid-market pricing or other pricing conventions within a bid-ask spread may be used as a practical expedient.

Investments in Entities That Calculate Net Asset Value Per Share. FASB ASC 820-10-50-6A provides a practical expedient to estimate fair value of an investment using net asset value per share or its equivalent if it has the following characteristics—

- it does not have a readily determinable fair value, *and*

- it is an investment in an investment company or is an investment in a real estate fund for which it is industry practice to measure investment assets at fair value on a recurring basis and to issue financial statements that are consistent with the measurement principles for investment companies.

The practical expedient permits not categorizing such investments within the fair value hierarchy. It is unlikely that small and midsize nonpublic entities will have such investments and, therefore, the exemption is not discussed further in this course.

Inactive Markets

The following factors should be evaluated to determine whether there has been a significant decrease in the volume or level of activity for an asset or liability when compared with normal market activity:

- Price quotations that are not based on current information or that vary substantially over time (or among market makers).

- Indexes that were previously highly correlated with fair value are now demonstrably uncorrelated with recent indications of fair value.

- Significant increase in implied liquidity risk premiums, yields, or performance indicators for observed transactions or quoted prices when compared with the entity's estimate of expected cash flows.

- Bid-ask spread that is wide or has significantly increased.

- Significant decline or absence of a primary market for new issuances of the asset or liability (or similar items).

- Little information is released publicly.

If, based on the preceding factors, there has been a significant decrease in the volume or level of activity in relation to normal market activity, quoted prices or transactions may not be indicative of fair value. For example, transactions may not be orderly (that is, they may be distressed or forced). In that case, a significant adjustment to the quoted prices or transactions may be necessary to determine fair value. Significant adjustments might also be needed, for example, to adjust a stale price or to make the price of a similar asset more comparable to the asset being measured.

GAAP does not prescribe a particular method for making adjustments to fair value. When there has been a significant decrease in volume or level of activity, it may be appropriate to change the valuation approach, valuation technique, or use multiple valuation approaches and/or valuation techniques. When the use of multiple valuation approaches or valuation techniques produces a range of fair value estimates, accountants should consider the reasonableness of the range; a wide range may indicate further evaluation is needed. In any event, the objective of fair value measurement remains the same—that is, to determine the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. An entity's intention to hold an asset or liability is not relevant to determining fair value.

If there has been a significant decrease in the volume or level of activity, it does not mean that all transactions are distressed or forced. Circumstances that may indicate distressed or forced transactions include the following:

a. Inadequate exposure to the market before the measurement date did not allow for normal marketing activities.

b. Even though there was an adequate marketing period, the seller marketed the asset or liability to a single buyer.

c. The seller is in (or near) bankruptcy or receivership.

d. The sale was necessary to meet regulatory or legal requirements (in other words, a forced transaction).

e. When compared to other recent transactions for the same or similar asset or liability, the transaction price is an outlier.

If the evidence indicates that the transaction is not orderly, little or no weight should be given to the transaction price when estimating fair value. However, if the evidence indicates the transaction is orderly, the transaction price should be considered when estimating fair value. An entity should consider the facts and circumstances when determining how much weight to place on the transaction price relative to other indications of fair value. If sufficient information is not available to determine whether a transaction is orderly, the transaction price can be considered when estimating fair value, but it cannot be the sole or primary determinant. An entity that is a party to the transaction is ordinarily presumed to have sufficient information to determine if the transaction is orderly.

Fair value measurement should include appropriate risk adjustments that are reflective of orderly transactions. In addition, if there has been a significant decrease in the volume or level of activity, quoted prices from third parties (such as brokers or pricing services) should be evaluated to determine whether they are based on orderly transactions or valuation techniques that reflect market participant assumptions. Less weight should be placed on quotes that do not reflect actual market transactions. Further, the nature of the quote should be considered. For example, some quotes may only be an indication of interest rather than an actual price at which a market participant would purchase or sell an asset or liability. More weight should be given to quotes based on binding offers.

CONSIDERATIONS RELATED TO MATERIALITY

Various financial reporting frameworks include a discussion of materiality in the context of the submission of financial statements.Those frameworks generally discuss materiality as follows:

- Misstatements, including omissions, are considered to be *material* in circumstances when they, individually or in the aggregate, could reasonably be expected to influence the decisions of the users of the financial statements.

- The size or nature of a misstatement (or a combination of both) in light of surrounding circumstances affect judgments about *materiality*.

- The common financial information needs of users *as a group* are considered when making *materiality* judgments. What may be considered *material* to a *specific* individual user is not considered.

The accountant has a responsibility to consider materiality in all SSARS engagements. This is evidenced throughout the SSARS:

- In a financial statement preparation engagement—

  - AR-C 70.18 indicates the accountant should disclose *material* departures from the applicable financial reporting framework.

- In a compilation engagement—

  - AR-C 80.13 indicates the accountant should read the financial statements and consider whether they are appropriate in form and free from obvious *material* misstatements.

  - AR-C 80.29 indicates the accountant should disclose *material* departures from the applicable financial reporting framework.

- In a review engagement—

  - AR-C 90.15 indicates the accountant should obtain an understanding of the entity's business and accounting principles used in order to identify areas where there is a greater chance that *material* misstatements may exist.

  - AR-C 90.17 indicates the accountant should design his or her review procedures to obtain limited assurance as a basis for reporting whether the accountant is aware of any *material* modifications that should be made to the financial statements.

  - AR-C 90.19 discusses applying analytical procedures to identify relationships and items that are unusual and may indicate a *material* misstatement.

  - AR-C 90.22f indicates the accountant should inquire of management concerning subsequent events that could have a *material* effect on the financial statements.

  - Both AR-C 90.28 and AR-C 90.30 address evaluating the *materiality* of the evidence obtained.

  - AR-C 90.34i requires the accountant to get a written representation from management that they believe that the effects of uncorrected misstatements are *immaterial*.

- - The review report even addresses *materiality* when it states:

> Based on my (our) review, I am (we are) not aware of any *material* modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America. [Emphasis added]

In compilations and reviews, the accountant's determination of materiality is a matter of professional judgment. When making this judgment, the accountant may consider the needs of the users of the financial statements. It is reasonable for the accountant to assume that these users—

- Have a reasonable knowledge of business, economic activities, and accounting.
- Have a willingness to study the information in the financial statements with a reasonable amount of diligence.
- Understand that materiality judgments are made when preparing, presenting, and reviewing the financial statements.
- Recognize that there are inherent uncertainties associated with the amounts included in the statements that involve estimates, judgment, or the consideration of future events.
- Make reasonable decisions on the basis of information in the financial statements.

SELF-STUDY QUIZ

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

12. Under what circumstances would an entity be considered to be a variable interest entity (VIE), assuming that the appropriate relationship between the entities exists?

    a. The entity has the equity to finance its own activities.

    b. The entity's equity investors have the power to direct all of its activities.

    c. Its equity investors have limited or no obligation to pay for its losses.

    d. The equity investors in the entity have the right to receive benefits from it.

13. Which of the following entities has presented *consolidated* financial statements?

    a. The Red Company presents a balance sheet, statement of income, statement of comprehensive income, statement of retained earnings, and a statement of cash flows.

    b. The Blue Company's statements aggregate its financial position with that of its subsidiary.

    c. The Green Company's statements present its financial position and its subsidiary's in columnar form.

    d. The Yellow Company and the Purple Company have common management and present their financial statements as one.

14. Which of the following would be a characteristic of an appropriate market participant when determining an asset's fair value?

    a. A related party of the entity or a member of management.

    b. Unfamiliar with the entity as to be unbiased.

    c. Able to conduct the transaction at this time.

    d. Participating in the exchange because of a contractual obligation.

15. Which of the following is considered a Level 1 input in the fair value hierarchy?

    a. A quoted price for an identical asset in an active market.

    b. A quoted price in an active market for a similar asset.

    c. Information developed by the entity using its own data.

    d. A quoted price for an identical asset in an inactive market.

16. Which of the following statements best describes how different financial reporting platforms discuss materiality?

    a. Materiality related to individual users of the financial statements is important.

    b. The size of a particular misstatement is the most important factor when determining materiality.

    c. Misstatements must be material on their own to be considered in relation to materiality.

    d. If misstatements and omissions would influence a user's decision, they are considered material.

SELF-STUDY ANSWERS

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

12. Under what circumstances would an entity be considered to be a variable interest entity (VIE), assuming that the appropriate relationship between the entities exists? **(Page 64)**

    a. The entity has the equity to finance its own activities. [This answer is incorrect. One condition for being considered a VIE is that its equity is *not* sufficient to finance its activities without additional subordinated financial support.]

    b. The entity's equity investors have the power to direct all of its activities. [This answer is incorrect. One condition that indicates an entity is a VIE is when the equity investors do *not* have the power to direct the activities of the entity that most significantly impact its economic performance.]

    c. Its equity investors have limited or no obligation to pay for its losses. [This answer is incorrect. An entity could be a VIE if its equity investors have an obligation to absorb its losses.]

    d. The equity investors in the entity have the right to receive benefits from it. [This answer is correct. Once the reporting entity determines that it has a relationship that requires it to consider the authoritative literature on accounting for a VIE, the next step is to consider whether the entity with which the reporting entity has the relationship is a VIE. Generally, an entity is considered to be a VIE if either of two conditions are met. One of those conditions is that the equity investors in the entity have the right to receive its benefits.]

13. Which of the following entities has presented *consolidated* financial statements? **(Page 71)**

    a. The Red Company presents a balance sheet, statement of income, statement of comprehensive income, statement of retained earnings, and a statement of cash flows. [This answer is incorrect. This is an example of a set of basic financial statements. There is not enough information included in this scenario to determine if the Red Company's financial statements are consolidated or not. Therefore, another answer to this question would be more appropriate.]

    b. The Blue Company's statements aggregate its financial position with that of its subsidiary. [This answer is correct. *Consolidated financial statements* combine a parent company's financial position and results of operations with those of its subsidiaries as if they were a single entity.]

    c. The Green Company's statements present its financial position and its subsidiary's in columnar form. [This answer is incorrect. *Consolidating financial statements* usually present the financial position and results of operations of the parent company and each of its subsidiaries in columnar form, together with columns that show eliminations of intercompany items and the consolidated totals.]

    d. The Yellow Company and the Purple Company have common management and present their financial statements as one. [This answer is incorrect. FASB ASC 810-10-55-1B states, "There are circumstances, however, where combined financial statements (as distinguished from consolidated financial statements) of commonly controlled companies are likely to be more meaningful that their separate financial statements." The guidance goes on to indicate that it might be more meaningful to use combined financial statements for (1) two or more companies that are related in their operations and are controlled by the same individual, (2) a group of unconsolidated subsidiaries, or (3) companies under common management (like the Yellow and Purple Companies in this scenario).]

14. Which of the following would be a characteristic of an appropriate market participant when determining an asset's fair value? **(Page 74)**

    a. A related party of the entity or a member of management. [This answer is incorrect. For a proper fair value determination, the hypothetical customers need to be independent of the reporting entity (i.e., not related parties).]

    b. Unfamiliar with the entity as to be unbiased. [This answer is incorrect. For this determination, market participants should be reasonably knowledgeable of the asset or liability and the transaction based on available information. Therefore, they should not be unfamiliar or flying blind about the transaction.]

    c. Able to conduct the transaction at this time. [This answer is correct. Fair value should be measured based on the assumptions market participants would use in pricing the asset or liability. One of the characteristics of a market participant for this determination is one who is able to conduct the transaction (e.g., has available funds in place).]

    d. Participating in the exchange because of a contractual obligation. [This answer is incorrect. When determining fair value, the market participant should be considered to be willing to conduct the transaction of its own accord. Therefore a seller who is forced to accept the price or conducts the transaction under duress would not qualify.]

15. Which of the following is considered a Level 1 input in the fair value hierarchy? **(Page 77)**

    a. A quoted price for an identical asset in an active market. [This answer is correct. A quoted price in an active market for an identical asset or liability is a Level 1 input. Level 1 inputs are considered to be the most reliable evidence of fair value. Active markets are those in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis.]

    b. A quoted price in an active market for a similar asset. [This answer is incorrect. This is considered a Level 2 input; therefore, it is not as desirable as a Level 1 input.]

    c. Information developed by the entity using its own data. [This answer is incorrect. This is an example of a Level 3 input and is the lowest level of the fair value hierarchy.]

    d. A quoted price for an identical asset in an inactive market. [This answer is incorrect. This type of input would be considered a Level 2 input.]

16. Which of the following statements best describes how different financial reporting platforms discuss materiality? **(Page 80)**

    a. Materiality related to individual users of the financial statements is important. [This answer is incorrect. The common financial information needs of users as a *group* are considered when making materiality judgments. What may be considered material to a *specific, individual* user is not considered.]

    b. The size of a particular misstatement is the most important factor when determining materiality. [This answer is incorrect. The size and nature of a misstatement (or a combination of both) in light of surrounding circumstances affect judgments about *materiality*.]

    c. Misstatements must be material on their own to be considered in relation to materiality. [This answer is incorrect. Misstatements are considered in relation to materiality both individually and in the aggregate.]

    d. If misstatements and omissions would influence a user's decision, they are considered material. [This answer is correct. Misstatements, including omissions, are considered to be *material* in circumstances when they, individually or in the aggregate, could reasonably be expected to influence the decisions of the users of the financial statements.]

Lesson 2: Partnerships

INTRODUCTION

This lesson takes a look at various issues associated with partnerships, including limited liability companies and limited liability partnerships.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine how partnerships deal with a variety of issues, including selecting an accounting basis, preparing financial statements using the contractual basis of accounting, federal income taxes, state income and franchise taxes, guaranteed payments to partners, loans between partners and the partnership, the equity section of the balance sheet, statements of changes in partners' capital, changes in partnership interest, investments in partnerships and joint ventures, partnership retirement plans, and changes in legal form of entity.
- Identify the advantages and disadvantages and related accounting and reporting issues of limited liability companies and limited liability partnerships.

Selection of an Accounting Basis

Generally, the partnership agreement dictates the accounting basis to be used in preparing a partnership's financial statements. Frequently, the agreement will specify the cash or tax basis of accounting, both of which are considered a special purpose framework for financial reporting. Because of the complicated Internal Revenue Service provisions applicable to partnerships, many accountants encourage their partnership clients to use the tax basis of accounting. Likewise, many limited partnerships are designed to provide maximum tax benefits to the partners, and great emphasis is placed on the tax basis of the assets. Thus, most frequently, partnerships present their financial statements on the tax basis of accounting.

Cash and tax basis statements do not purport to present financial position and results of operations in accordance with GAAP. Thus, partnership financial statements presented on the cash or tax basis are not described in terms that are generally applicable to GAAP basis statements unless the financial statement titles are appropriately modified (AR-C 80.A28 and AR-C 90.A81). For example, instead of "Balance Sheet," the title "Balance Sheet—Tax Basis" may be used. Similarly, instead of "Income Statement," the title "Statement of Revenues and Expenses—Tax Basis" may be used. Also, a statement of cash flows is not required for tax or cash basis partnership financial statements because the statements do not purport to present financial position and results of operations in accordance with GAAP.

If the partnership agreement does not specify a basis of accounting other than GAAP, the partnership financial statements should include all statements required by GAAP, which would include:

a. Balance Sheet.

b. Statement of Income.

c. Statement of Changes in Partners' Capital.

d. Statement of Cash Flows.

The basic financial statement presentation principles discussed in Lesson 1 are applied to partnership financial statements presented on the accrual basis. The following section discusses financial statements that are not in accordance with either GAAP nor the cash or tax basis. That may happen for example, when a partnership agreement stipulates the basis of accounting, which results in financial statements prepared in accordance with a *contractual basis of accounting*.

FINANCIAL STATEMENTS THAT ARE PREPARED IN ACCORDANCE WITH A CONTRACTUAL BASIS OF ACCOUNTING

AR-C 80.05 and AR-C 90.05 state that the *contractual basis of accounting* is a *special purpose framework*. A special purpose framework includes the cash basis, tax basis, regulatory basis, and other basis, as well as the contractual basis of accounting. Thus, the reporting guidance in AR-C 80 and AR-C 90 for contractual basis financial statements is substantially the same as it is for cash and tax basis statements. For example, reports on all special purpose financial statements are required to refer to management's responsibility to determine the applicable financial reporting framework if there is a choice of financial reporting frameworks and include a separate paragraph that (a) indicates that the financial statements were prepared in accordance with the applicable special purpose framework (in this instance, contractual); (b) refers to the note that describes the framework (if applicable); and (c) states that the framework is a basis of accounting other than GAAP.

In addition, when reporting on contractual basis financial statements, the accountant is required to—

a. Describe in the report, or refer to a note that describes, the purpose for which the financial statements have been prepared. The purpose of this is to avoid misunderstandings when the financial statements are used for purposes other than those for which they were intended. This note also may describe any significant interpretations of the contract as discussed in item b (AR-C 80.20 and AR-C 90.42).

b. Modify the report if significant interpretations of the contract are not adequately described in the financial statements (AR-C 80.19 and AR-C 90.41).

If the accountant has reviewed the contractual basis financial statements, AR-C 90.44 requires the accountant to also add to the report an other-matter paragraph that restricts the use of the report. Although not required for compiled contractual basis financial statements, it would be a good idea to add the restricted use paragraph to the compilation report.

If there are departures from the reporting requirements of the partnership agreement (that is, the contractual basis), the accountant should modify the report for a departure from the special purpose framework (AR-C 80.29–.33 and AR-C 90.56–.60).

Client Interpretations of the Partnership Agreement

When the accountant is engaged to compile or review financial statements prepared in accordance with a contractual basis of accounting, AR-C 80 and AR-C 90 require that the accountant's report include a description of any significant interpretations made by the client regarding provisions of the agreement. The interpretation descriptions that would be included will vary depending upon the terms of the agreement.

CONSIDERATIONS RELATED TO FEDERAL INCOME TAXES

Income from a partnership is taxed to the partners rather than to the partnership. Therefore, the financial statements of the partnership would not include federal income tax expense or the related liability. If the statement of income shows net income after federal income taxes, it is not prepared in accordance with GAAP (Q&A 7200.02). However, when the partnership's financial statements are presented on an accrual basis, it may be appropriate to record a liability for any substantial partner withdrawals that are anticipated in order to pay income taxes and that are formally approved before the balance sheet date. Although not required by GAAP, it is a best practice for the financial statements to disclose (a) that the partnership does not pay income taxes and (b) any anticipated withdrawals by partners to pay income taxes, whether or not recorded as a liability in the financial statements. With respect to item (b), the accountant would consider disclosing any withdrawals made since the balance sheet date. An illustrative note follows:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Federal Income Taxes

The partnership is not a taxpaying entity for federal income tax purposes, and thus no income tax expense has been recorded in the statements. Income from the partnership is taxed to the partners in their individual returns. The partners customarily make substantial capital withdrawals in April of each year to pay their personal income tax liabilities. At December 31, 20X1, $75,000 has been deposited in a partnership savings account in anticipation of partner withdrawals.

FASB ASC 740-10-50-16 requires public entities that are not subject to income taxes because income is taxed directly to their owners to disclose that fact and the net difference between the financial and tax bases of the entities' assets and liabilities. The requirement generally applies to mutual funds, real estate investment trusts, regulated investment companies, and certain partnerships. Although FASB ASC 740-10 does not require nonissuers to disclose similar information, it is a best practice to disclose that income is taxed directly to the owners and that as a result, the partnership did not recognize a provision for income taxes, as illustrated in the preceding paragraph. Also, in some circumstances, nonissuers may consider it useful to disclose their temporary differences. Disclosing the nature of temporary differences will likely satisfy the primary users of the financial statements and, thus, it should not be necessary to disclose the amount of the basis differences.

Occasionally, a partnership agreement requires that a provision for income taxes be computed at a specified rate and be included as an expense of the partnership. The inclusion of such a tax provision is a departure from GAAP and should be reported as such.

Accounting for Uncertainty in Income Tax and Partnerships

The measurement and disclosure principles of FASB ASC 740-10 generally do not affect the financial statements of an entity that is not potentially subject to income taxes. To illustrate, assume that the IRS examines the Form 1065 of a partnership and disallows certain deductions. Any additional income taxes will be imposed on the partners rather than the partnership, and accordingly, FASB ASC 740-10 would have no effect on the partnership's financial statements.

However, while it is unlikely that a partnership will pay a tax, it can be subject to failure-to-file penalties. Some businesses cross borders and do not register in another state and then later have to pay penalties for failure to timely file a return. Even the federal government now charges penalties of so much per partner per month for late filing. In addition, there is a disclosure requirement even if there are no uncertain tax positions. FASB ASC 740-10 as it relates to pass-through entities is discussed in more detail in Lesson 3.

CONSIDERATIONS RELATED TO STATE INCOME AND FRANCHISE TAXES

If a state or other taxing authority levies a tax on the partnership and the tax is based on net income, the financial statements would show the tax as an expense of the partnership. Because the payment of income taxes by a partnership is rare, the financial statements would disclose the nature of the tax (if material).

GUARANTEED PAYMENTS TO PARTNERS

Guaranteed payments to partners are often made as salary payments for services or interest on capital accounts. The conventional method of accounting for such payments is to treat them as part of the allocation of partnership net income, rather than as an expense in determining net income. However, in some situations, e.g., when the payments are designed to reflect reasonable compensation for services, it may be more meaningful to show the payments as expenses of the partnership. Whenever guaranteed payments are material, the method of accounting for them would be included in the accounting policies disclosures.

WHEN THERE ARE LOANS BETWEEN PARTNERS AND THE PARTNERSHIP

Loans from partners to the partnership, which are greater than the capital required to be contributed, are conventionally accounted for as loans rather than capital. In most states, such loans have preferential treatment over capital upon dissolution. Thus, they would be classified in the balance sheet as liabilities rather than capital, and interest on the loans should be recorded as an expense of the partnership. The appropriate disclosures required for related party transactions and notes payable are illustrated in the following example:

> NOTE C—NOTES PAYABLE TO PARTNERS
>
> The notes payable to partners represent unsecured demand loans payable to certain partners. Interest on the notes is payable quarterly at the prime interest rate charged by local banks.

Loans to partners, which are not intended to be withdrawals of capital or profits, are considered assets of the partnership by law in most states. These loans should be recorded in the balance sheet as an asset rather than a reduction of capital. Again, a related party disclosure, such as the following, is appropriate:

> NOTE D—LOANS TO PARTNERS
>
> Loans to partners are 180-day unsecured loans due May 31, 20X1. The loans bear interest at the rate of 10% per annum, payable at maturity.

FASB ASC 850-10 defines *related parties* and sets the requirements for related party disclosures.

THE EQUITY SECTION OF THE BALANCE SHEET

The equity section of the balance sheet of a partnership is labeled "Partners' Capital." In some situations, it may be desirable to disclose the capital accounts of the individual partners or classes of partners. Examples of such presentations on the face of the balance sheet follow:

PARTNERS' CAPITAL	
John Jones	$ 50,000
Jim Smith	130,000
Bill Adams	85,000
	$ 265,000

PARTNERS' CAPITAL	
General Partner	$ 110,000
Limited partners	(1,275,000)
	$ (1,165,000)

The same type of presentation might also be made in a note, rather than on the face of the statements.

Generally, no distinction is made on the balance sheet between capital contributed, beginning capital, or retained earnings, as is done for corporations. However, as discussed in the following section, a statement of changes in partners' capital may be necessary.

THE STATEMENT OF CHANGES IN PARTNERS' CAPITAL

As discussed in Lesson 1, FASB ASC 505-10-50-2 requires changes in the stockholders' equity accounts to be *disclosed* whenever the financial statements purport to present both financial position and results of operations. While not specifically discussed in accounting literature, it is a best practice for financial statements on the cash or tax basis of accounting or financial statements of entities other than corporations to disclose changes in the components of the capital or equity section of the balance sheet. Accordingly, changes in partners' capital would be disclosed. In many cases, these changes can be best disclosed by presenting a combined statement of income and changes in partners' capital as follows:

NET INCOME	$ 150,000
BEGINNING PARTNERS' CAPITAL	225,000
Drawings for the year	(145,000)
Additional capital contributed	30,000
ENDING PARTNERS' CAPITAL	$ 260,000

It may be preferable to present a separate statement of changes in partners' capital in circumstances such as the following:

a. When more detail or description of the transactions is desired.

b. When comparative statements are presented.

c. When changes in individual partners' capital accounts are presented.

Exhibit 2-1 and Exhibit 2-2 show examples of separate "Statements of Changes in Partners' Capital."

Exhibit 2-1

Example Statements of Changes in Partners' Capital

ABC DISTRIBUTING PARTNERSHIP
STATEMENTS OF CHANGES IN PARTNERS' CAPITAL
Years Ended December 31, 20X2 and 20X1

	20X2	20X1
BEGINNING PARTNERS' CAPITAL	$ 110,000	$ 75,000
Net income for the year	90,000	60,000
Capital contributed	—	15,000
Capital withdrawn	(55,000)	(40,000)
ENDING PARTNERS' CAPITAL	$ 145,000	$ 110,000

See accompanying notes and accountant's report.

* * *

Exhibit 2-2

Example Statements of Changes in Partners' Capital

XYZ PARTNERSHIP
STATEMENT OF CHANGES IN PARTNERS' CAPITAL
Year Ended December 31, 20X2

	Partner X	Partner Y	Partner Z	Total
BEGINNING CAPITAL	$ 50,000	$ 75,000	$ 40,000	$ 165,000
Share of net income	85,000	60,000	45,000	190,000
Capital contributed	—	—	10,000	10,000
Drawings	(80,000)	(70,000)	(40,000)	(190,000)
ENDING CAPITAL	$ 55,000	$ 65,000	$ 55,000	$ 175,000

See accompanying notes and accountant's report.

* * *

DEALING WITH CHANGES IN PARTNERSHIP INTEREST

FASB ASC 805, *Business Combinations,* provides acquired entities the option of applying pushdown accounting in their separate financial statements as of the date a controlling interest is obtained. The option can be elected each time an event occurs in which an acquirer obtains control of an acquiree. FASB ASC 805-50-25-7 indicates that electing pushdown accounting in a reporting period after a change in control occurs is a change in accounting principle. In addition, FASB ASC 805-50-25-9 states that, if the option is elected, it is irrevocable. Because the option is only available when there has been a change in control, it is not available for a combination of commonly-controlled entities.

According to FASB ASC 805-50-30-10, pushdown accounting generally pushes down the values recorded by the acquiring entity in a business combination accounted for under FASB ASC 805. However, although goodwill may be recognized, FASB ASC 805-50-30-11 prohibits including bargain purchase gains in earnings. Instead, they are to be recognized as an adjustment of equity. In addition, under FASB ASC 805-50-30-12, any acquisition-related liability incurred by the acquirer is pushed down only if the liability represents an obligation of the acquiree.

An in-depth discussion of push-down accounting is beyond the scope of this course; however, more detailed guidance is available in *PPC's Guide to Preparing Financial Statements.* The guidance applies to all forms of entities and is not specific to partnerships.

INVESTMENTS IN PARTNERSHIPS AND JOINT VENTURES

The accounting requirements for investments in corporations apply to investments in partnerships. FASB ASC 810-10-15-3 requires consolidation when the reporting entity controls the partnership, and FASB ASC 323-30-25-1 requires using the equity method when the reporting entity does not control the partnership but has the ability to exercise significant influence over it.

If the equity method is used to account for an investment in a partnership, e.g., when the investor has more than a 20% interest and has the ability to exercise significant influence over partnership policies, the investor would record its prorata share of partnership profits or losses by adjusting the carrying amount of its investment in the partnership.

The equity method ordinarily is discontinued when the investment and net advances are reduced to zero. However, if the investor has guaranteed obligations of the partnership or is otherwise committed to provide further financial support, losses would continue to be recorded by the investor to the extent of the additional funds committed. An investment in a partnership accounted for by the equity method that has been reduced below zero would be presented as a liability in the balance sheet.

GAAP also states that the equity method is not a valid substitute for consolidation. Accountants should consider whether FASB ASC 810, *Consolidation*, requires consolidation because the reporting entity controls the partnership through a means other than ownership of a majority voting interest. FASB ASC 810 provides guidance on criteria for determining when looking at nominal voting rights is not effective for determining if the reporting entity has a controlling financial interest in the partnership and provides guidance on looking for a controlling financial interest in those situations.

A limited partnership has at least one general partner and one limited partner, but it may have more than one general partner and/or more than one limited partner. Often, the general partner interest is smaller than the limited partner interest.

For years beginning after December 15, 2016, GAAP requires a limited partnership to be evaluated for consideration as a variable interest entity unless the limited partners possess, at a minimum, either of the following:

a. the substantive ability to dissolve the limited partnership or remove the general partner interest without cause, which is referred to as *substantive kick-out rights*, or

b. substantive participating rights.

If those characteristics are present, the limited partnership is evaluated for consolidation as a voting interest entity. (However, even entities that possess those characteristics might be considered VIEs if they meet any of the other criteria in FASB ASC 810-10-15-14.)

FASB ASC 810-10-15-14 and 810-10-25-14 specify two conditions that must exist for kick-out rights to be substantive:

a. they generally must be capable of being exercised by a single limited partner or a vote of a simple majority of the limited partner interest, and

b. there must be no significant barriers to the exercise of the rights.

Substantive participating rights provide the limited partner interest with the ability to block or participate in significant financial and operating decisions that would be expected to be made in the ordinary course of the limited partnership's business. FASB ASC 810-10-25-11 gives two examples of substantive participating rights:

a. Hiring, terminating, and determining the compensation of management responsible for the implementation of policies and procedures.

b. Making operating and capital decisions, such as establishing budgets.

If a limited partnership qualifies for evaluation as a voting interest entity because the limited partners possess the preceding rights, FASB ASC 810-10-25-1A establishes the presumption that the owner of a majority of the limited partnership's kick-out rights through voting interests has a controlling financial interest in the limited partnership.

FASB ASC 810-10-25-5 states that judgment is required to assess whether the presumption of control can be overcome, but the limited partner with the majority of kick-out rights through voting interests does *not* have a controlling financial interest if other limited partners have substantive participating rights. That is, if a noncontrolling limited partner can veto the controlling limited partner's decisions that would cause the general partner to take actions that are significant in the ordinary course of business, then the presumption of control is overcome. The evaluation of noncontrolling rights is made when a majority of kick-out rights through voting interests is obtained, and should be re-evaluated if there is a significant change in the terms or the ability of a noncontrolling limited partner to exercise its approval or veto rights.

Thus, under the voting interests model, a general partner will not consolidate a limited partnership because, by definition, the limited partners possess either substantive kick-out rights or substantive participating rights. However, under the variable interests model, if the general partner meets both the "power" and "losses and benefits" tests, then, according to FASB ASC 810-10-25-38C, a kick-out or participating right exercisable unilaterally by a single entity (including its related parties and de facto agents) would be needed for the general partner to avoid consolidation. Because it seems uncommon for small and midsize nonpublic entities to grant limited partners substantive kick-out or participating rights, in most cases limited partnerships will be considered VIEs and the general partner will be considered the primary beneficiary.

A summary of the accounting considerations when the reporting entity is a partner in a limited partnership follows:

Step 1 Does the limited partnership qualify for consideration as a voting interest entity?

a. Yes. Go to step 2.

b. No. Follow the consolidation guidance in the VIE Subsections of FASB ASC 810 to determine if consolidation is required.

Step 2 Does the reporting entity own a majority of the limited partnership's kick-out rights through voting interests?

a. Yes. Go to step 3.

b. No. Consolidation is not required. The reporting entity should ordinarily account for its interest in the limited partnership using the equity method.

Step 3 Do noncontrolling partners hold substantive participating rights?

a. Yes. Consolidation is not required. The reporting entity should ordinarily account for its interest in the limited partnership using the equity method.

b. No. The reporting entity must include the consolidated financial results of the limited partnership in its financial statements.

ACCOUNTING FOR A PARTNERSHIP'S RETIREMENT PLANS

A partnership may set up a retirement plan patterned after profit sharing, pension, or other types of employee benefit plans used by corporations. There is no authoritative guidance on how to account for such plans in a partnership. Thus, there is diversity in practice as to whether payments to partners and related retirement benefits are an expense to the partnership or a distribution of partner equity.

Retirement plans are required by federal income tax laws to include present and future employees other than the partners. Therefore, it seems logical that payments to such plans would be recorded as expenses of the partnership rather than as withdrawals of capital. When the partnership makes payments to employees' IRAs as well as to those of the partners (SEP-IRAs), the payments would be recorded as an expense of the partnership.

Regardless of the method used to account for partner payments, the significant provisions of the partnership's plan and the accounting policy for the partners' portion would be properly disclosed in the notes to the financial statements.

CHANGING THE LEGAL FORM OF ENTITY

A change in the legal form of business (for example, from or to a partnership) is not considered a change in accounting principle (or change in reporting entity) and is, therefore, not subject to the accounting and disclosure requirements of FASB ASC 250-10. Absent any authoritative accounting and disclosure guidance that addresses such a change, it is a best practice to disclose the change in legal form and/or tax status be made in the notes to the financial statements.

When one or more prior years' statements are presented after a change to or from a partnership, the question often arises as to whether prior year statements should be modified. FASB ASC 250-10 implies that a change to or from partnership status is not viewed as a change in accounting principle. Therefore, retrospective application is inappropriate. However, in order to enhance the comparability, it may be necessary to modify the format of the prior year statements. If that is done, a note such as the one illustrated in the "Comparative Financial Statements" paragraph in the next section may be included to disclose the change.

As a practical matter, especially when a corporation is converted to a partnership, accountants may choose to recommend that their partnership clients present single-period statements for the first reporting period following the change.

SELF-STUDY QUIZ

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

17. Which of the following should be done when a partnership prepares its financial statements using the contractual basis of accounting?

    a. A balance sheet, statement of income, statement of changes in partners' capital, and statement of cash flows should be included.

    b. Describe in the accountant's report or include reference to a note that describes the purpose for which the statements were prepared.

    c. Include an other-matter in a compilation report that restricts the report's use to appropriate people.

    d. Make a special notification to the IRS because of the greater tax issues that apply to partnership financial statements prepared on this basis of accounting.

18. When would an entity stop using the equity method to account for an investment in a partnership?

    a. When the investor's interest is more than 20%.

    b. When the investment is reduced below zero.

    c. When the financial statements would otherwise be consolidated.

    d. When use of the pushdown method of accounting is elected.

SELF-STUDY ANSWERS

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

17. Which of the following should be done when a partnership prepares its financial statements using the contractual basis of accounting? **(Page 88)**

    a. A balance sheet, statement of income, statement of changes in partners' capital, and statement of cash flows should be included. [This answer is incorrect. If the partnership agreement does not specify a basis of accounting other than GAAP, the partnership financial statements should include all statements required by GAAP: (1) balance sheet, (2) statement of income, (3) statement of changes in partners' capital, and (4) statement of cash flows. When the contractual basis of accounting (a special purpose framework) is used, GAAP requirements might not apply in the same way.]

    b. Describe in the accountant's report or include reference to a note that describes the purpose for which the statements were prepared. [This answer is correct. When reporting on contractual basis financial statements, the accountant is required to, among other things, describe in the report, or refer to a note that describes, the purpose for which the financial statements have been prepared. The purpose of this is to avoid misunderstandings when the financial statements are used for purposes other than those for which they were intended.]

    c. Include an other-matter in a compilation report that restricts the report's use to appropriate people. [This answer is incorrect. If the accountant has reviewed the contractual basis financial statements, AR-C 90.44 requires the accountant also add to the report an other-matter paragraph that restricts the use of the report. Although not required for compiled contractual basis financial statements, the restricted use paragraph could be added to the compilation report. Therefore, while optional for a compilation report, this paragraph is mandatory for a review report.]

    d. Make a special notification to the IRS because of the greater tax issues that apply to partnership financial statements prepared on this basis of accounting. [This answer is incorrect. Because of the complicated IRS provisions applicable to partnerships, many accountants encourage their partnership clients to use the tax basis of accounting. However, no special notification is required under SSARS No. 21 if the partnership uses a different special purpose framework, including the contractual basis.]

18. When would an entity stop using the equity method to account for an investment in a partnership? **(Page 92)**

    a. When the investor's interest is more than 20%. [This answer is incorrect. FASB ASC 323-30-25-1 requires using the equity method when the reporting entity does not control the partnership but has the ability to exercise significant influence over it. This is typically considered to be when the investor has more than 20% interest and has the ability to exercise significant influence over partnership policies.]

    b. When the investment is reduced below zero. [This answer is correct. The equity method is normally discontinued when the investment and net advances are reduced to zero. However, if the investor has guaranteed obligations of the partnership or is otherwise committed to provide further financial support, losses would continue to be recorded by the investor to the extent of the additional funds committed. An investment in a partnership accounted for by the equity method that has been reduced below zero would be presented as a liability in the balance sheet.]

    c. When the financial statements would otherwise be consolidated. [This answer is incorrect. GAAP states that use of the equity method is not a valid substitute for consolidation.]

    d. When use of the pushdown method of accounting is elected. [This answer is incorrect. As described in FASB ASC 805, *Business Combinations,* acquired entities have the option of applying pushdown accounting in their separate financial statements as of the date a controlling interest is obtained. However, this election relates to acquired entities, not to investments the entity makes in a different partnership.]

LIMITED LIABILITY COMPANIES (LLCs)

LLCs are business entities created under state law that can be used in all states. LLCs are owned by members and combine many of the tax advantages of a partnership with the liability protection of a corporation. In many cases, LLCs are more flexible than S corporations. Each state establishes its own LLC rules and characteristics.

Advantages and Disadvantages of LLCs

Advantages. Advantages of LLCs include the following:

- They have limited liability (that is, members are not personally liable for the LLC's debts or liabilities, except to the extent of their investment and any remaining capital commitment to the LLC).
- The number of members is not limited.
- Members may be corporations, trusts, partnerships, LLCs, or others.
- Double taxation affecting most C corporations is avoided. Income is passed through to the members for taxation purposes.
- Members can participate in managing the LLC.
- Distributions to members do not have to be directly proportional to the members' ownership percentages as they do for S corporations.
- They can have different classes of ownership.
- A member's creditor has limited power to satisfy his or her claim with the LLC's assets because the creditor may only receive a charging order allowing receipt of the distributions that would have been made to the debtor-member.

Disadvantages. Disadvantages of LLCs include the following:

- They sometimes have a limited life, such as by termination on the death or bankruptcy of a member.
- Transfer of interests is more difficult. (Under most LLC statutes, a member can assign his or her interest to a nonmember, but the assignee cannot become a substitute member and acquire all of the attributes of the assigning member's interest unless the remaining members consent to the transfer. Without such approval, the assignee is entitled only to receive the distributions to which the assigning member otherwise would be entitled. Accordingly, interests in LLCs formed under those statutes are not freely transferable.)
- The enacted laws vary from state to state. Therefore, the LLC must determine how it will be treated for both tax and liability purposes in other states.
- Members who have management authority, debt responsibility, or who materially participate are exposed to self-employment tax.

Assisting Clients. Clients considering establishing a new business as an LLC or converting an existing entity into an LLC need to carefully consider the advantages and disadvantages as previously discussed. Accountants may assist clients by researching the LLC statutes of the states in which the client plans to do (or does) business. Knowledge of those factors, along with an understanding of the basic characteristics of an LLC, would allow accountants to assist their clients in making the best decision. (Note that when researching LLC statutes, accountants often consult with the client's attorney.)

Organization

Although there is a Uniform Limited Liability Company Act, most states have not adopted it as the model for state LLC statutes. Instead, the state statutes typically represent a mix of provisions derived from state business corporation acts and limited partnership acts. Accordingly, differences exist among the various state statutes. By necessity, this discussion of LLCs is general in nature and should not be considered a substitute for obtaining a thorough understanding of applicable state LLC statutes.

Articles of Organization. An LLC is established by filing articles of organization with the appropriate state agency. Generally, an LLC can conduct any lawful business except for those expressly prohibited by the applicable LLC statute or which are prohibited under other state statutes regulating particular business activities (e.g., usually banking and insurance). Most state LLC laws require that the company's name include a designation of its legal status. Examples of such required designations include "Limited Liability Company," "LLC," "Limited Company," and "LC."

Operating Agreement. The owners of an LLC are referred to as members, and their rights and powers are usually provided in the company's "operating agreement." The operating agreement is the LLC equivalent of a partnership agreement or corporate bylaws.

General Tax Treatment

The attractiveness of LLCs depends on their treatment as partnerships for federal income tax purposes. LLCs with more than one member are by default treated as partnerships for federal income tax purposes. (LLCs also can elect to be treated as corporations; however, that option is attractive only in limited circumstances, such as when S corporation status is desired to minimize the owners' liability for payroll taxes on their earnings.)

Single-member LLCs. A single member LLC is a disregarded entity by default. That means its existence will be ignored for federal income tax purposes, and the income and expenses of the LLC will be taxed to the LLC's owner. (Alternatively, a single-member LLC can elect to be taxed as a corporation.) For example, an LLC business owned by a single individual is treated as a sole proprietorship. An LLC business wholly owned by another legal entity, such as a corporation, is treated as an unincorporated branch of the parent entity. A corporation owning a single-member LLC is not required to file a consolidated return, but merely reports the LLC's income and expenses as if they were the corporation's.

Classification Election. LLCs wishing to elect a classification different from its initial default classification who wish to be treated as corporations must make an election on Form 8832 (Entity Classification Election). The same is true when an LLC later wishes to change its existing classification. An entity that elects to change its classification cannot change its classification again during the 60 months after the effective date of the election [Reg. 301.7701-3(c)(1)(iv)]. This rule does not apply to a newly formed entity's election out of its default classification at inception or if the organization's business is actually transferred to another entity.

Conversion of an Existing Entity to an LLC. Internal Revenue Service private letter rulings generally have held that the conversion of a partnership to an LLC (whether by merger or otherwise) is treated as a continuation of the partnership with no tax consequences, unless the conversion causes a shift in the allocation of liabilities among the partners/members. If a shift in liabilities causes a deemed distribution of cash in excess of a member's basis in the LLC, a gain will be recognized. A shift in liabilities may also result in the recognition of gain if a member's amount at risk is reduced below zero because of the liability shift. The conversion of a corporation to an LLC (assuming the LLC is treated as a partnership) will result in the recognized liquidation of the corporation and the formation of a new partnership for federal income tax purposes, with all of the accompanying tax consequences. Gain or loss will be recognized by the shareholders, as well as by the corporation on the disposition of its property upon liquidation.

Accounting and Reporting Issues

While LLCs are unique legal entities, they do not give rise to a significant number of accounting or reporting issues that differ from those of partnerships. FASB ASC 272-10 provides guidance on applying existing accounting literature to LLCs. [That guidance also applies to limited liability partnerships (LLPs), which are discussed later in this lesson]

The remainder of this section discusses some of the unique issues accountants typically address when compiling or reviewing the financial statements of LLCs.

Financial Statement Headings. The headings of an LLC's financial statements should clearly identify the entity as an LLC. FASB ASC 272-10-45-2 requires this even in jurisdictions where LLCs are not required by law to include the LLC designation in their names.

Federal Income Taxes. If the LLC is considered a partnership for federal income tax purposes, income is taxed to the members rather than to the LLC. As noted earlier in this lesson regarding partnerships, the financial statements of the LLC should not include federal income tax expense or the related liability. If the statement of income shows net income after federal income taxes, it is not prepared in accordance with GAAP. However, if the LLC's financial statements are presented on an accrual basis, it may be appropriate to record a liability for any substantial member withdrawals that are anticipated in order to pay income taxes and that are formally approved before the balance sheet date. Although not required by GAAP, it is a best practice for the financial statements to disclose (a) that the LLC does not pay federal income taxes and (b) any anticipated withdrawals by members to pay income taxes, whether or not recorded as a liability in the financial statements. With respect to item (b), the accountant needs to consider disclosing any withdrawals made since the balance sheet date. An illustrative note follows:

> NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
>
> <u>Federal Income Taxes</u>
>
> The Company is not a taxpaying entity for federal income tax purposes, and thus no income tax expense has been recorded in the statements. Income of the Company is taxed to the members in their respective returns. The members customarily make substantial capital withdrawals in April of each year to pay their federal income tax liabilities. At December 31, 20X1, $75,000 has been deposited in a Company savings account in anticipation of member withdrawals.

FASB ASC 740-10 requires issuers that are not subject to income taxes because income is taxed directly to their owners to disclose that fact and the net difference between the financial and tax bases of the entities' assets and liabilities. The requirement generally applies to mutual funds, real estate investment trusts, regulated investment companies, and certain partnerships. Although FASB ASC 740-10 does not require nonissuers to disclose similar information, it is a best practice to disclose that income is taxed directly to the owners and that as a result, the company did not recognize a provision for income taxes, as illustrated in the preceding paragraph. Also, in some circumstances, nonissuers may consider it useful to disclose their temporary differences. The disclosure of the nature of temporary differences seems to satisfy the primary users of the financial statements and, thus, it would not be necessary to disclose the amount of the basis differences.

An LLC's operating agreement may also require that a provision for income taxes be computed at a specified rate and be included as an expense of the LLC. The inclusion of such a tax provision is a departure from GAAP and would be reported as such.

State Income and Franchise Taxes. Depending on the state of organization, an LLC may be subject to significant state income or franchise taxes. If a state or other taxing authority levies a tax on the LLC and the tax is based on net income, as previously discussed regarding partnerships, the financial statements should show the tax as an expense of the LLC. Furthermore, if taxable income differs significantly from book income, deferred taxes should be recorded in accordance with FASB ASC 740-10. The financial statements also should disclose the nature of the tax (if material). If the LLC's tax status in a jurisdiction changes from taxable to nontaxable, any deferred tax assets and liabilities related to that jurisdiction should be eliminated.

Equity Section of the Balance Sheet. Since owners of an LLC are referred to as members, FASB ASC 272-10-45-3 states that the equity section of the balance sheet should be labeled "Members' Equity."

Ownership interests may be represented by membership certificates or shares. For example, an LLC may issue Class I shares that have unlimited voting rights and Class II shares that have only limited rights and privileges. Different classes of shares may also have different rights as to the distribution of assets upon dissolution of the company. If ownership interests are represented by membership certificates or shares, the equity section of the balance sheet will resemble that of a corporation.

If ownership interests are not represented by membership certificates or shares, the equity section of the balance sheet will resemble that of a partnership. Generally, only a single amount will be shown. However, if it is desirable to disclose separately the equity accounts of those members who have been designated as managers, a presentation such as the following can be made:

MEMBERS' EQUITY		
Managing members	$	75,000
Nonmanaging members		25,000
	$	100,000

FASB ASC 272-10-45-1 states that the components of members' equity may be presented on the face of the balance sheet or in the notes.

The operating agreement of some LLCs may provide that unless the transfer (for example, by assignment or inheritance) of a member's interest is approved by the remaining members, the transferee will not be permitted to participate in the management of the LLC or become a member. Instead, the transferee is entitled only to receive the distributions to which the assigning member otherwise would be entitled. If desired, it seems appropriate for the portion of members' capital owned by such non-approved transferees to also be disclosed.

FASB ASC 272-10-45-4 and 45-5 states that if a member's equity account is less than zero, a deficit should be reported even though the member's liability may be limited. In addition, if the LLC records amounts due from members for capital contributions, those amounts should be presented as deductions from members' equity rather than as assets.

Conversion of an Existing Entity to an LLC. LLCs frequently are formed when an existing entity is converted to LLC status. The converting entity often is a partnership. However, C corporations and S corporations may also merge with an LLC or convert to LLC status. An LLC formed by the conversion of a partnership generally is considered a continuation of the partnership, and no new taxable entity comes into being. However, the conversion of a corporation to LLC status results in the creation of a new entity for tax purposes. (According to FASB ASC 250-10, a change in the legal form of business is not considered a change in reporting entity.) *PPC's Guide to Preparing Financial Statements* provides guidance on the accounting issues surrounding the conversion of a corporation to a partnership. That guide can be ordered by calling (800) 431-9025 or at **tax.thomsonreuters.com**.

Comparative Financial Statements. When one or more prior years' financial statements are presented after a change to an LLC, the question arises whether the prior year statements should be modified. As discussed above, changes in the legal form of business, for example, from an S corporation or partnership to an LLC, are not changes in the reporting entity. Consequently, retrospective application is not appropriate. However, in order to enhance the comparability, it may be necessary to modify the format of the prior year statements. If that is done, a note such as the following can be included to disclose the change:

> NOTE X—RECLASSIFICATIONS
>
> Certain accounts in the prior-year financial statements have been reclassified for comparative purposes to conform with the presentation in the current-year financial statements.

As a practical matter, especially when a corporation is converted to an LLC, accountants may choose to recommend that their LLC clients present single-period statements for the first reporting period following the change.

While changing the legal form of an entity to an LLC does not constitute a change in reporting entity, formation of an LLC may in some cases result in a change in reporting entity. For example, if commonly-owned companies for which combined financial statements had not previously been presented were combined into a single LLC, a change in reporting entity would occur. In that case, the disclosures required by FASB ASC 250-10 should be made and the change should be retrospectively applied to the financial statements for all prior periods presented.

LLC Financial Statement Disclosure Requirements. An LLC needs to disclose the following:

- A description of any limitation of members' liability. (The identification of the entity as an LLC or partnership alerts financial statement readers to the general limitation of members' liability. Therefore, the additional requirement of FASB ASC 272-10-50-3 to describe limitations seems only to relate to *special* limitations seems, such as those imposed by some states on the managing member's liability or the special liability considerations for members of professional limited liability entities.)

- The amount of each class of members' interests if more than one class exists, each having varying rights, preferences, and privileges of each class. [As discussed earlier in this section, if the LLC does not report the equity amount of each class separately in the equity section of the balance sheet, the equity amounts must be disclosed in the notes (FASB ASC 272-10-50-1).]

- The date the LLC will cease to exist if it has a finite life.

- The separate components of members' equity, such as undistributed earnings, earnings available for withdrawal, or unallocated capital, if the LLC maintains such components. (This disclosure is permitted but not required.)

- The fact that the company's assets and liabilities previously were held by a predecessor entity or entities (for LLCs formed by combining entities under common control or by converting from another type of entity). These LLCs are also encouraged to make the relevant disclosures in FASB ASC 805-10-50-2.

- Any relevant income tax disclosures required by FASB ASC 740-10. (Those disclosure requirements were discussed further earlier in this section.)

Disclosure of Change in Legal Form and/or Tax Status. It is a best practice to also disclose the change in legal form and/or tax status. Conversion of an existing entity to an LLC was discussed previously.

Single-member LLCs. For accounting and reporting purposes, a single-member LLC would follow the rules for LLCs, not those of proprietorships. There may, however, be a few presentation differences that need to be considered. For example, for a single-member LLC, the report should be addressed to the *member* of XYZ LLC versus to the *members* of XYZ LLC. In addition, the equity statement for a single-member LLC is called the "Statement of *Member's* Equity" versus the "Statement of *Members'* Equity." Practitioners may also want to consider adding a footnote to single-member LLC statements noting that the statements do not include personal accounts (as in the case of a proprietorship).

LLC Taxed as an S Corporation. For U.S. GAAP financial statement reporting purposes, an LLC being taxed as an S corporation will follow the accounting and presentation rules for an LLC, with the exception of the financial statement tax footnote that will discuss the S corporation taxing rules. However, if the client uses the tax basis of accounting for financial statement purposes, the S corporation accounting and presentation rules are followed.

LIMITED LIABILITY PARTNERSHIPS (LLPs)

LLPs are a special type of general partnership that exists under state laws. LLPs were enacted in response to the concern that a partner of a professional firm can be held liable for the malpractice of another partner in the same firm.

The partners in an LLP remain personally liable for the commercial and other obligations of the entity, their own acts and omissions, and the acts and omissions of persons under their supervision. However, LLP partners are not liable for acts and omissions by the other LLP partners or nonsupervised employees. In many states, the LLP statutes provide that LLP partners are not personally liable for the LLP's contract liabilities unless they are personally guaranteed. In such states, LLPs are similar to LLCs with regard to the issue of owner exposure to the entity's liabilities.

Advantages and Disadvantages of LLPs

Advantages. The major advantages of LLPs are favorable pass-through taxation rules; the flexibility to structure ownership interests with varying rights to cash flow, liquidation proceeds, and tax allocations; and the low cost of converting to LLP status. Most states only require the filing of a registration statement and payment of a fee (which can be significant) to form an LLP. No new partnership agreement is required.

Disadvantages. The primary disadvantage of LLPs is the liability in some states of the partners for the debts and other obligations of the LLP (exclusive of liability for professional acts and omissions of others). Thus, an LLP sometimes provides its partners with less liability protection than is available to members of an LLC but more than is available under a general partnership. In addition, the annual registration fee in some states is significant (as much as $5,000) and some states require significant levels of malpractice insurance.

LLPs Compared to LLCs. From a liability limitation standpoint, the use of an LLC is sometimes preferable to the use of an LLP. However, LLPs are available for professional practices in some states where LLCs are not.

The administrative aspects of adopting LLP status for a professional practice (for example, meeting the state board of accountancy rules) generally are minimal in comparison to obtaining permission to operate as an LLC, especially in the case of a multistate practice.

Accounting and Reporting Issues

Similar to LLCs, LLPs do not give rise to a significant number of accounting or reporting issues that differ from those of partnerships. FASB ASC 272-10 provides guidance on applying existing accounting literature to LLPs (as well as LLCs). In fact, FASB ASC 272-10 states in its guidance that the collective term "limited liability companies" includes both LLCs and LLPs. Therefore, the unique accounting and reporting issues for LLCs discussed earlier in this lesson also apply to LLPs.

SELF-STUDY QUIZ

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

19. What is one advantage of a limited liability company (LLC)?

    a. They can have a limited life.

    b. The ease of transferring interests.

    c. Members are exempt from self-employment tax.

    d. One member is not liable for all of the entity's debts.

20. What is the purpose of an LLC's operating agreement?

    a. Determining the rights and powers of its members.

    b. Establishing the LLC within the state that it will operate.

    c. Ensuring compliance with the Uniform Limited Liability Company Act.

    d. Electing a different classification for the LLC.

SELF-STUDY ANSWERS

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

19. What is one advantage of a limited liability company (LLC)? **(Page 97)**

    a. They can have a limited life. [This answer is incorrect. Sometimes, LLCs have a limited life, such as by termination on the death or bankruptcy of a member. This is one of the disadvantages of using the LLC structure.]

    b. The ease of transferring interests. [This answer is incorrect. One of the disadvantages of LLCs is that the transfer of interests is more difficult.]

    c. Members are exempt from self-employment tax. [This answer is incorrect. One of the disadvantages of being an LLC is that members who have management authority, debt responsibility, or who materially participate are exposed to self-employment tax.]

    d. One member is not liable for all of the entity's debts. [This answer is correct. One advantage of operating as an LLC is that they have limited liability. This means that members are not personally liable for the LLC's debts or liabilities, except to the extent of their investment and any remaining capital commitment to the LLC.]

20. What is the purpose of an LLC's operating agreement? **(Page 98)**

    a. Determining the rights and powers of its members. [This answer is correct. The owners of an LLC are referred to as members, and their rights and powers are usually provided in the company's "operating agreement." The operating agreement is the LLC equivalent of a partnership agreement or corporate bylaws.]

    b. Establishing the LLC within the state that it will operate. [This answer is incorrect. An LLC is established by filing articles of organization (not an operating agreement) with the appropriate state agency.]

    c. Ensuring compliance with the Uniform Limited Liability Company Act. [This answer is incorrect. Although there is a Uniform Limited Liability Company Act, most states have not adopted it as the model for state LLC statutes. Instead, the state statues typically represent a mix of provisions from state business corporation acts and limited partnership acts. However, though this is the case, whether or not a state uses the Uniform Limited Liability Company Act has no bearing on the information in an LLC's operating agreement. The operating agreement has a different focus.]

    d. Electing a different classification for the LLC. [This answer is incorrect. LLCs wishing to elect a classification different from their initial default classification who wish to be treated as corporations must make an election on Form 8832 (Entity Classification Election). The same is true when an LLC later wishes to change its existing classification. However, Form 8832 is different from an LLC's operating agreement.]

Lesson 3: S Corporations

INTRODUCTION

Because they are viewed legally as corporations, authoritative literature has not addressed accounting, presentation, and reporting issues of S corporations separate from those of conventional corporations (hereafter referred to as "C corporations"). For most general ledger account groupings, the accounting treatment is, indeed, the same as that for a C corporation. However, for the federal income tax (normally absent in S corporations) and retained earnings account groupings, subtle and sometimes major differences are caused by the unique federal income tax treatment of S corporations.

With the liability protection and pass-through taxation they provide, S corporation status is the most common choice of business structure. Therefore, practitioners should be aware of the unique accounting issues of S corporations. This lesson explores these issues and develops guidance based on (a) the Subchapter S Revision Act of 1982 and subsequent amendments, acts, and technical corrections affecting that guidance, (b) logical extensions and inferences of GAAP, and (c) state corporation law. Much of GAAP for shareholders' equity is traditional and taken from leading textbooks. Discussions relating to state corporation law are based on the Model Business Corporation Act that has been adopted, at least in part, in most states. Because corporation law may vary among states, procedures presented in this lesson may require adaptation to conform to a particular state's law.

LLC Taxed as an S Corporation

For U.S. GAAP financial statement reporting purposes, an LLC being taxed as an S corporation will follow the accounting and presentation rules for an LLC, with the exception of the tax footnote that discusses the S corporation taxing rules. However, if the client uses a tax basis for financial statement purposes, the S corporation accounting and presentation rules should be followed.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize appropriate financial statement presentation for S corporations, as well as procedures they may use to account for retained earnings.
- Identify the effects of losses, tax/book differences, and termination on an S corporation's retained earnings account.

FINANCIAL STATEMENT PRESENTATION FOR S CORPORATIONS

Balance Sheet

The balance sheet of an S corporation is the same as for a C corporation. Accordingly, the balance sheet should generally report a single retained earnings amount. The components of retained earnings can be disclosed in the notes to financial statements or in a separate statement of retained earnings if the information would be meaningful to the users.

Statement of Income

The details of the statement are the same as for a C corporation except that, as a general rule, no federal income tax expense is reported. A supplementary schedule showing the allocation of taxable income to shareholders and reconciling the total taxable income to net income can be used to provide additional informative disclosures to shareholders. See Exhibit 3-4 for an illustration.

Statement of Retained Earnings

Although not required by GAAP as explained above, some practitioners use a statement of retained earnings to disclose the changes in components of retained earnings of S corporations. Each component of retained earnings can be identified separately with disclosure of its beginning balance, transactions or events that caused changes, and ending balance. As an alternative to this statement, disclosure is sometimes made in the notes.

Statement of Comprehensive Income

The statement of comprehensive income of an S corporation is the same as for a C corporation. See the discussion on reporting comprehensive income in Lesson 1. Regardless of the method used, the statement displaying comprehensive income must include net income, the components of other comprehensive income, and a total comprehensive income amount.

Statement of Cash Flows

This statement is the same as for a C corporation.

Comparative Financial Statements

When one or more prior years' statements are presented after a change to or from S corporation status, the question arises whether prior year statements should be modified. A change in the legal form of business (for example, from or to an S corporation) is not a change in reporting entity according to FASB ASC 250. Also, FASB ASC 250 implies that a change to or from S corporation status is not viewed as a change in accounting principle. Therefore, retrospective application is inappropriate. However, in order to enhance comparability, it may be necessary to modify the format of the C corporation's income statements to focus on income before taxes as well as on net income. Disclosure of the change in legal form and/or tax status should also be made.

Summary of Unique Disclosures

The following are this course's recommendations for disclosures that are unique to S corporations (this list may not be all-inclusive):

a. The S corporation status of the corporation should be disclosed either in the notes or the accountant's report. It is a best practice to disclose the S corporation status parenthetically in the accountant's report.

b. A description of the tax consequences of the S corporation election should be presented in the notes. Sample wording follows.

> NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
>
> Income taxes
>
> The Company has elected to be taxed under the provisions of Subchapter S of the Internal Revenue Code. Under those provisions, the Company does not pay federal corporate income taxes on its taxable income (. . . is not allowed a net operating loss carryover or carryback as a deduction). Instead, the stockholders are liable for individual federal income taxes on their respective shares (. . . include their respective shares of the Company's net operating loss in their individual income tax returns).

c. Dividends paid after the S corporation election terminates, e.g., special post-termination distributions of the *Accumulated Adjustments Account* should be disclosed as a subsequent event.

d. If there is a danger that the S election could be retroactively terminated by the IRS, the contingency (federal income taxes) should be evaluated in the context of FASB ASC 450. Consideration should also be given to FASB ASC 740.

e. Although not required, the amount of accumulated earnings not distributed but previously taxed to the stockholders.

f. Although not required, the details of the various retained earnings accounts are sometimes disclosed in the statement of retained earnings or in a note.

S Corporation Tax Uncertainties

FASB ASC 740-10 clarifies that if income taxes paid by the entity are attributable to the—

a. entity, they should be accounted for following the provisions of FASB ASC 740.

b. owners, they should be accounted for as a transaction with owners.

For example, a state that recognizes the Subchapter S election may nevertheless require the entity to pay an amount computed by applying the state income tax rate to the entity's taxable income allocated to an out-of-state owner. The individual would include the allocated income in his return and recognize a tax credit for the payment by the entity. The payment should be considered attributable to the owner and shown as a dividend in the entity's financial statements.

FASB ASC 740-10 also clarifies that—

a. the determination of attribution should be made for each jurisdiction where the entity is subject to income taxes and determined on the basis of laws and regulations of the jurisdiction, and

b. management's determination of the taxable status of the entity, including its status as a pass-through entity, is a tax position that is subject to consideration of uncertainty.

To illustrate the accounting considerations, assume that a corporation that has elected Subchapter S status takes the position that it does not have nexus with a state that does not recognize that election. The corporation should evaluate whether the position would more likely than not be sustained by the state in an examination. That evaluation should consider the positions taken by the state in applying nexus requirements, such as how many years are considered open if tax would be assessed retrospectively and whether the state has adopted thresholds of taxable income attributable to the state below which it will not assert nexus.

As a practical matter, it is a best practice for the entity to also consider the materiality of the effects of the position being denied. For example, reallocation of taxable income to the state may enable the entity to reduce taxable income originally allocated to other states, resulting in recovery of state income taxes paid.

Finally, FASB ASC 740-10 clarifies that the reporting entity must consider the tax positions of all entities within the group of entities whose financial results are presented in consolidated or combined financial statements. To illustrate the accounting considerations, assume that a S corporation has a controlling financial interest in a C corporation that has not elected Subchapter S status. Since the S corporation has a controlling financial interest in the C corporation, it must include the consolidated financial results of the C corporation in its financial statements. The tax positions taken by the C corporation are subject to the requirements of FASB ASC 740-10 in determining whether income taxes for *the corporation* should be recognized in the consolidated financial statements.

RETAINED EARNINGS ACCOUNTING PROCEDURES

General Requirements

Although practitioners may show a single balance sheet caption and amount for retained earnings of an S corporation, maintenance of separate retained earnings accounts in the books is good accounting practice for the following reasons:

a. Maintenance of separate retained earnings accounts is generally necessary for proper tax accounting of an S corporation.

b. More often than not, the primary users of financial statements of S corporations are shareholders who are interested in the impact of the corporate earnings on their personal tax returns.

Terminology and Definitions

Because many of the terms and concepts of S corporation accounting have novel and specific meanings, it is helpful to clarify them before describing accounting procedures. The following definitions of terms and associated abbreviations are used throughout the remainder of this lesson.

a. *Accumulated Adjustments Account (AAA).* An amount defined by federal tax regulations that reflects the aggregate amount of undistributed income and gains that have been taxed to the shareholders after 1982. The AAA is increased by taxable income and by separately stated items of income such as net capital gains; it is *not* increased by tax-exempt income. The AAA is reduced by tax losses and separately stated items of deduction such as charitable contributions and net capital losses, and it is also reduced by such nondeductible items as fines and penalties. However, expenses related to tax-exempt income do *not* reduce the AAA. Distributions paid to shareholders reduce the AAA to the extent that such distributions do not exceed the adjusted AAA balance at year-end (before considering distributions for the year). The amounts included in the AAA also affect the shareholders' tax bases in the shares.

b. *Accumulated Earnings and Profits (AEP).* An amount defined by federal tax regulations that applies to S corporations with previous Subchapter C status; it generally does not apply to corporations that immediately elect S corporation status. AEP generally represents retained earnings existing when S corporation status is attained, with certain adjustments required by the federal tax regulations (for example, in calculating AEP, straight-line depreciation must be used in place of accelerated depreciation methods). AEP may be reduced only by dividends to shareholders after the AAA has been distributed, unless the corporation elects otherwise as provided by the income tax rules. No new AEP may be generated by S corporations (unless another corporation with AEP is merged). Distributions of AEP do not reduce the shareholders' tax bases in the shares.

   The Small Business Jobs Protection Act of 1996 eliminated AEP accumulated during any pre-1983 S corporation tax year, provided the corporation was an S corporation during its first tax year beginning after 1996. The Small Business and Work Opportunity Tax Act of 2007 completed the process and eliminated such AEP accumulated during any pre-1983 S corporation tax year, effective for the S corporation's first tax year beginning after May 25, 2007, even though the S corporation was not an S corporation for its first tax year beginning after 1996. As a result of these changes, an S corporation can only have AEP accumulated during a prior C corporation year or acquired from a C corporation through a tax-free corporate reorganization.

   AEP will be negative if past C corporation losses exceed income; negative AEP does not affect the tax status of future distributions to shareholders. However, its existence may limit the total amount of dividends that may be declared because of state laws. Negative AEP remains on the books indefinitely.

c. *Tax Temporary Adjustments (TTA).* A term developed for this course to represent retained earnings changes that result when tax/book differences originate and then reverse. Such differences are not recognized for tax purposes in the AAA and AEP calculations. Unlike other retained earnings (see item d.), TTA are not viewed as part of shareholders' tax bases in their shares. The use of the TTA account is necessary to maintain a double-entry financial accounting system while maintaining the AAA, AEP, and shareholders' bases at amounts recognized for tax purposes. This account will usually return to zero when timing differences completely reverse. In some cases, though, TTA will remain on the books indefinitely, particularly if the status of the S corporation changes.

d. *Other Retained Earnings (ORE).* Any amount that would be viewed as retained earnings under GAAP and state corporation law that is included in shareholders' bases for tax purposes, but is not included in the specific definitions above. The amount of ORE is increased by tax-exempt income and is reduced by expenses incurred to generate this tax-exempt income and by dividends paid to shareholders in excess of aggregate distributions from the AAA and AEP. Although this account is treated as paid-in capital for tax purposes, i.e., the items affect the shareholders' bases, GAAP and state corporation law imply that it should be viewed as retained earnings for accounting purposes.

The ORE generally tracks changes in the other adjustments account (OAA), which is maintained for tax purposes. [For a comprehensive discussion of the OAA, see the IRS instructions to Form 1120S relating to Schedule M-2, columns (a) and (b).] However, as discussed in the previous paragraph, the ORE is a broader account maintained for financial accounting purposes.

The next several sections of this lesson describe and illustrate accounting procedures designed to maintain these separate components of retained earnings for tax purposes and yet in total equal GAAP retained earnings.

ILLUSTRATIONS FOR TRACKING SEPARATE RETAINED EARNINGS ACCOUNTS

Although separate retained earnings accounts may be maintained for the reasons discussed earlier in this lesson, the balance sheet of an S corporation generally reflects a single retained earnings account. As noted previously, there is no requirement to disclose separate retained earnings accounts. Consequently, many practitioners do not do so. As a result, the examples in the following sections illustrate the accounting entries tracking the separate retained earnings accounts, but do not illustrate separate statements of retained earnings.

Accounting procedures for tracking retained earnings of S corporations are illustrated by considering hypothetical companies reflecting different situations (the year, 20X4):

a. Brand NU Company, a newly formed corporation that elected S corporation status on January 1, 20X4.

b. Ceecorp Company, a previously existing conventional corporation that elected S corporation status on January 1, 20X4.

Each firm has four 25% shareholders: Mr. Able, Ms. Baker, Dr. Cole, and Mr. Dale. Each corporation uses the calendar year for tax and financial reporting purposes.

Procedures for Newly Formed S Corporations

Selected accounts from the Brand NU Company adjusted trial balance as of December 31, 20X4, are presented in Exhibit 3-1. During the accounting period following incorporation and election, the company has recorded transactions and made adjusting entries in accordance with GAAP. Distributions of $60,000 paid during the period are recorded in an account titled "Dividends."

Exhibit 3-1

Selected Accounts from Adjusted Trial Balance

BRAND NU COMPANY
ADJUSTED TRIAL BALANCE
December 31, 20X4
(Selected Accounts Only)

	Debit	Credit
Retained earnings		$ 0
Sales		2,000,000
Cost of goods sold	$ 1,200,000	
Officer and employee salaries	250,000	
Operating expenses	350,000	
State income taxes	40,000	
Officer life insurance premiums	30,000	
Interest income (tax exempt)		50,000
Dividends	60,000	

* * *

The various revenue and expense accounts are closed to an income summary account at the end of the accounting period. The entry to record income would be as shown in Exhibit 3-2. The $180,000 balance in the income summary account represents net income as computed under GAAP. Taxable income that flows through to shareholders, however, is only $160,000 because of the $20,000 net permanent difference between tax-exempt interest income ($50,000) and nondeductible officer life insurance premiums ($30,000). The taxable income of $160,000 is credited to the AAA, and the $20,000 difference between tax-exempt income and nondeductible life insurance premiums is credited to ORE. The dividends of $60,000 are less than taxable income and would thus be deducted entirely from the AAA. If tax/book timing differences exist, a third retained earnings account (TTA) is necessary as discussed in a later section. Closing entries to allocate income and dividends to retained earnings are shown in Exhibit 3-3.

Exhibit 3-2

Entry to Record Income

	DR	CR
Sales	$ 2,000,000	
Interest income (tax exempt)	50,000	
Cost of goods sold		$ 1,200,000
Officer and employee salaries		250,000
Operating expenses		350,000
State income taxes		40,000
Officer life insurance premiums		30,000
Income summary		180,000

* * *

Exhibit 3-3

Closing Entries

	DR	CR
Income summary	$ 180,000	
Retained earnings—AAA		$ 160,000
ORE		20,000
Retained earnings—AAA	60,000	
Dividends		60,000

* * *

Practitioners may wish to present, as supplementary information, a schedule of income allocation similar to Exhibit 3-4, which reconciles net income and taxable income allocated to shareholders. Such presentations are useful to shareholders in understanding the relationship of the financial statement income of the company to their personal tax consequences.

Exhibit 3-4

Schedule of Income Allocation

BRAND NU COMPANY
SCHEDULE OF INCOME ALLOCATION
Year Ended December 31, 20X4

TAXABLE INCOME ALLOCATED TO SHAREHOLDERS		
Able		$ 40,000
Baker		40,000
Cole		40,000
Dale		40,000
	TOTAL TAXABLE INCOME	160,000
TAX-EXEMPT INCOME		50,000
NONDEDUCTIBLE EXPENSES		(30,000)
	NET INCOME	$ 180,000

See accountant's report.

*　　*　　*

Recommended disclosures for S corporation financial statements were summarized earlier in this lesson.

Procedures for Previous Conventional Corporations

Selected accounts from Ceecorp Company's adjusted trial balance at December 31, 20X4, are shown in Exhibit 3-5. The conventional corporate retained earnings account at December 31, 20X3, in the amount of $100,000, became AEP on January 1, 20X4. This example ignores tax/book temporary differences arising before S corporation status is attained. These differences are discussed later in this lesson.)

Exhibit 3-5

Selected Accounts from Adjusted Trial Balance

CEECORP COMPANY
ADJUSTED TRIAL BALANCE
December 31, 20X4
(Selected Accounts Only)

	Debit	Credit
Retained earnings—AEP		$ 100,000
Sales		2,000,000
Cost of goods sold	$ 1,200,000	
Officer and employee salaries	300,000	
Operating expenses	461,000	
State income taxes	2,000	
Officer life insurance premiums	30,000	
Interest income (tax exempt)		50,000
Dividends	6,000	

*　　*　　*

The revenue and expense accounts are closed to the income summary account as shown in Exhibit 3-6 with a resulting net income computed under GAAP of $57,000.

Exhibit 3-6

Entry to Record Income

	DR	CR
Sales	$ 2,000,000	
Interest income (tax exempt)	50,000	
Cost of goods sold		$ 1,200,000
Officer and employee salaries		300,000
Operating expenses		461,000
State income taxes		2,000
Officer life insurance premiums		30,000
Income summary		57,000

* * *

Income would be allocated as shown in Exhibit 3-7. The $37,000 taxable income would flow through to the shareholders. This amount is recorded as the AAA. The $50,000 of tax-exempt interest income less the nondeductible life insurance premiums of $30,000 becomes part of ORE because this amount is added directly to shareholders' bases in the shares. If tax/book timing differences exist, adjustments of the AAA and ORE accounts are necessary. This topic is discussed later in this lesson.

Exhibit 3-7

Closing Entry to Allocate Income to Retained Earnings

	DR	CR
Income summary	$ 57,000	
Retained earnings—AAA		$ 37,000
ORE		20,000

* * *

Assume that Ceecorp had a poor financial year in 20X4, so that only $6,000 in distributions were paid—$1,500 to each shareholder. This amount is less than taxable income; hence, it reduces only the AAA as shown in Exhibit 3-8.

Exhibit 3-8

Closing Entry to Allocate Dividends to Retained Earnings

	DR	CR
Retained earnings—AAA	$ 6,000	
Dividends		$ 6,000

* * *

SELF-STUDY QUIZ

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

21. Which of the following basic financial statements is generally presented differently for an S corporation than it would be for a C corporation?

    a. The balance sheet.

    b. The statement of income.

    c. The statement of comprehensive income.

    d. The statement of cash flows.

22. What is the *accumulated adjustment account* (AAA)?

    a. The amount of retained earnings when S corporation status is elected by the entity.

    b. The amount of changes in retained earnings that result from tax/book differences that originate and then reverse.

    c. An amount that reflects aggregated undisturbed income and gains taxed to shareholders after 1982.

    d. Any amount that is viewed under GAAP and state corporation law as retained earnings and would be included in the shareholders' bases for tax purposes but not included in other definitions.

SELF-STUDY ANSWERS

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

21. Which of the following basic financial statements is generally presented differently for an S corporation than it would be for a C corporation? **(Page 105)**

    a. The balance sheet. [This answer is incorrect. The balance sheet of an S corporation is the same as for a C corporation. Accordingly, the balance sheet should generally report a single retained earnings amount.]

    b. The statement of income. [This answer is correct. The details of the statement of income presented by an S corporation are generally the same as for a C corporation, except that, as a general rule, no federal income tax expense is reported. A supplementary schedule showing the allocation of taxable income to shareholders and reconciling the total taxable income to net income can be used to provide additional informative disclosures to shareholders.]

    c. The statement of comprehensive income. [This answer is incorrect. The statement of comprehensive income of an S corporation is the same as for a C corporation. Regardless of the method used, the statement displaying comprehensive income must include net income, the components of other comprehensive income, and a total comprehensive amount.]

    d. The statement of cash flows. [This answer is incorrect. The statement of cash flows for an S corporation is the same as that for a C corporation. Therefore, there is a better answer choice to this question.]

22. What is the *accumulated adjustment account* (AAA)? **(Page 108)**

    a. The amount of retained earnings when S corporation status is elected by the entity. [This answer is incorrect. *Accumulated earnings and profits* (AEP) is an amount defined by federal tax regulations that applies to S corporations with previous Subchapter C status; it generally does not apply to corporations that immediately elect S corporation status. AEP, not AAA, generally represents retained earnings existing when S corporation status is attained, with certain adjustments required by the federal tax regulations.]

    b. The amount of changes in retained earnings that result from tax/book differences that originate and then reverse. [This answer is incorrect. *Tax temporary adjustments* (TTA) is a term developed for this course to represent retained earnings changes that result when tax/book differences originate and then reverse. Such differences are not recognized for tax purposes in the AAA and AEP calculations.]

    c. An amount that reflects aggregated undisturbed income and gains taxed to shareholders after 1982. [This answer is correct. The AAA is an amount defined by federal tax regulations that reflects the aggregate amount of undistributed income and gains that have been taxed to an S corporation's shareholders after 1982.]

    d. Any amount that is viewed under GAAP and state corporation law as retained earnings and would be included in the shareholders' bases for tax purposes but not included in other definitions. [This answer is incorrect. *Other retained earnings* (ORE) is a term for any amount that would be viewed as retained earnings under GAAP and state corporation law that is included in shareholders' bases for tax purposes but is not included in the other specific definitions provided in this lesson (AAA, AEP, and TTA).]

THE EFFECT OF LOSSES ON RETAINED EARNINGS ACCOUNTS

S corporation losses passed through to shareholders are deductible to the extent of shareholders' adjusted bases in the corporation's stock plus debt due them from the corporation. Losses that exceed shareholders' stock and debt bases may be carried over and deducted by them in succeeding years when the corporation has income until completely absorbed or the S corporation election is terminated.

Accounting procedures for S corporation losses parallel the procedures previously illustrated for profits. The AAA is reduced (debited) for the amount of loss that is passed through to the shareholders. The AAA is also reduced for nondeductible expenses not related to tax-exempt income. Tax-exempt income less related expenses is credited to ORE. AEP accounts are not affected by S corporation losses. The AAA may carry a debit balance as a result of losses. Distributions made while the AAA has a debit balance would be made from AEP, assuming that total retained earnings has a credit balance. If total retained earnings amounts to a deficit, dividends cannot normally be legally declared even though AEP may have a credit balance. State corporation law generally recognizes retained earnings as a single amount.

To illustrate loss accounting procedures, refer to the examples for Ceecorp Company for the year 20X4 (Exhibit 3-5 through Exhibit 3-8). Procedures are essentially the same for all S corporations; hence, they are not illustrated separately. At the end of 20X4, Ceecorp has AAA with a $31,000 balance and ORE with a $20,000 balance. Assume that shareholders had paid $40,000 ($10,000 each) for their shares. Therefore, shareholders' bases in the shares would be $91,000 ($22,750 each). Also assume that Dr. Cole has a note payable from the corporation of $5,000.

Assume further that Ceecorp realizes a net loss of $200,000 in 20X5, and that there are no tax/book differences. In this case, the income summary account would have a debit balance of $200,000. The entry to close the net loss is shown in Exhibit 3-9. As a result, the AAA now has a debit balance of $169,000. The capital stock, paid-in capital, and notes payable accounts are not reduced because these items are not legally canceled.

Exhibit 3-9

Closing Entry to Allocate Net Loss to Retained Earnings

	DR	CR
Retained earnings—AAA	$ 200,000	
Income summary		$ 200,000

* * *

The entire $200,000 loss is allocated to shareholders ($50,000 each). The maximum loss that can be deducted by the shareholders in 20X5, however, is $96,000 ($22,750 each to Able, Baker, and Dale, and $27,750 to Cole). The remaining $104,000 loss can be deducted in future profitable years ($26,000 to each shareholder). (Disclosure of the future tax effect for shareholders should be considered.)

THE EFFECT OF TAX/BOOK DIFFERENCES ON RETAINED EARNINGS ACCOUNTS

S corporations do not normally pay federal income taxes and thus do not report federal tax liabilities and deferred taxes. Nevertheless, it may be necessary to record originating and reversing tax/book temporary differences because these differences affect the various retained earnings accounts and sometimes require that additional retained earnings accounts be established. The accounting procedures vary depending on the origin of the S corporation and whether the temporary differences originated before or after S corporation status was attained.

Many tax/book differences originate with income under GAAP in excess of taxable income. Therefore, the following discussions and illustrations incorporate this presumption. All of the illustrations are based on the following data: assume that during 20X4, a company purchased assets for $50,000. For tax purposes, the cost will be recovered using three-year MACRS. For accounting purposes, the company records straight-line depreciation over five years with no residual value. A summary of the relevant data is as follows:

Year	Cost Recovered		Depreciation		Difference	Cumulative Difference
20X4	$ 16,665	(33.33%)	$ 10,000	(20%)	$ 6,665	$ 6,665
20X5	22,225	(44.45%)	10,000		12,225	18,890
20X6	7,405	(14.81%)	10,000		(2,595)	16,295
20X7	3,705	(7.41%)	10,000		(6,295)	10,000
20X8	—		10,000		(10,000)	—
TOTALS	$ 50,000		$ 50,000		$ -0-	

Differences Originating after S Corporation Status Is Attained

To illustrate accounting procedures for newly created corporations that immediately elect S corporation status, refer to the adjusted trial balance for Brand NU Company for the year 20X4 in Exhibit 3-1 and assume:

a. Depreciation expense of $10,000 is included in operating expenses.

b. GAAP net income for 20X4 is $180,000.

c. GAAP net income includes $50,000 of nontaxable income and $30,000 of nondeductible expenses.

d. Taxable income for 20X4 is $153,335 ($180,000 GAAP income − $6,665 excess MACRS depreciation − $50,000 nontaxable income + $30,000 nondeductible expenses).

When closing the income summary account, it is necessary to use an additional retained earnings account called TTA to record the tax/book temporary difference. This is illustrated in Exhibit 3-10.

Exhibit 3-10

Closing Entry to Allocate Income to Retained Earnings

	DR	CR
Income Summary	$ 180,000	
Retained earnings—AAA		$ 153,335
ORE		20,000
Retained earnings—TTA		6,665

* * *

The amount of TTA represents taxable income that will be allocated to shareholders in future years and thus should be disclosed separately. The supplementary schedule of income allocation for 20X4 is shown in Exhibit 3-11. It would be a best practice to include an explanatory note describing the nature of material differences between book and taxable income.

Exhibit 3-11

Supplementary Schedule of Income Allocation

BRAND NU COMPANY
SCHEDULE OF INCOME ALLOCATION
Year Ended December 31, 20X4

TAXABLE TO SHAREHOLDERS IN 20X4		
Able		$ 38,334
Baker		38,334
Cole		38,334
Dale		38,333
	TOTAL TAXABLE INCOME	153,335
TAXABLE TO SHAREHOLDERS IN FUTURE YEARS		6,665
TAX-EXEMPT INCOME		50,000
NONDEDUCTIBLE EXPENSES		(30,000)
	NET INCOME	$ 180,000

See accountant's report.

* * *

Assume net income computed under GAAP for years 20X5 through 20X8 is as follows:

20X5	$ 200,000
20X6	250,000
20X7	150,000
20X8	190,000

Assume further that there are no tax/book differences except for the difference between cost recovery and straight-line depreciation expense. Entries to close net income for each of these years are presented in Exhibit 3-12. Observe that the TTA account is reduced to zero when the temporary difference completely reverses in 20X8.

Exhibit 3-12

Entries to Close Net Income to Retained Earnings

	DR	CR
20X5 Income summary	$ 200,000	
Retained earnings—TTA		$ 12,225
Retained earnings—AAA		187,775
20X6 Income summary	250,000	
Retained earnings—TTA	2,595	
Retained earnings—AAA		252,595
20X7 Income summary	150,000	
Retained earnings—TTA	6,295	
Retained earnings—AAA		156,295
20X8 Income summary	190,000	
Retained earnings—TTA	10,000	
Retained earnings—AAA		200,000

* * *

Differences Originating before S Corporation Status Is Attained

Tax/book temporary differences originating before S corporation status is attained produce some interesting questions:

a. How should pre-S corporation temporary differences be reflected in the retained earnings accounts?

b. How should the reversal of these pre-S corporation differences be recorded?

c. What should be done with existing deferred taxes, if any?

Because temporary differences produce a difference between GAAP income and taxable income, the GAAP retained earnings will differ from the tax concept of AEP for C corporations.

At the time of conversion to S corporation status, AEP, as defined for tax purposes, is frozen. The GAAP retained earnings balance can be segregated into two or more parts at the time a corporation converts to an S corporation.

a. *AEP.* As defined for tax purposes.

b. *TTA.* The net temporary differences.

c. *ORE.* Permanent differences, etc., that do not enter the calculation of AEP.

These separate component accounts for retained earnings preserve the tax concept of AEP yet maintain a GAAP retained earnings balance.

Although the temporary differences originating before attaining S corporation status will reverse, they will not generate a tax liability so long as S corporation status is maintained. Thus, deferred taxes previously recorded will not become due. FASB ASC 740 requires that existing deferred tax assets and liabilities be eliminated through a charge or credit to income tax expense for the period in which the enterprise ceases to be a taxable enterprise.

Because the concept of a TTA account is not commonly known, many existing S corporations may include within their various retained earnings accounts elements of tax/book differences and/or deferred taxes. It is a best practice to establish a TTA account and reallocate within the retained earnings accounts any material amounts of tax/book differences. This will allow the accounting records to properly reflect GAAP and yet maintain retained earnings accounts for the tax concepts of AEP, AAA, etc.

Tax/Book Differences Existing When S Corporation Status Terminates

Tax/book temporary differences existing when S corporation status terminates are discussed later in this lesson.

Tax Basis of Accounting

Converting from GAAP to the tax basis of accounting at the time of conversion to S corporation status will eliminate the need to account for tax/book temporary differences. Practitioners should consider this option in light of the intended uses of the financial statements.

THE EFFECT OF TERMINATION OF THE S CORPORATION ELECTION ON RETAINED EARNINGS ACCOUNTS

When an S corporation election is terminated, it is necessary for financial accounting purposes to merge retained earnings items that have resulted from income that has flowed through and been taxed to shareholders (AAA) with ORE. The merged retained earnings account should then be separated from retained earnings such as AEP that have resulted from earnings that were taxable to the corporation. Distributions from the former are generally viewed as tax-free returns of capital for tax purposes, whereas distributions from the latter are generally taxable to shareholders as are any other dividends.

When a corporation terminates its S corporation election, it has a specified period during which it can distribute all of the AAA; any AAA *not* distributed becomes part of ORE. Alternatively, the corporation (to avoid the accumulated earnings tax or personal holding company tax) can elect to have all of its distributions during this period taxed as dividends and not reduce the basis of the shares. If this treatment is elected, the distribution is recorded as a debit to AEP. In subsequent periods, once S corporation status has ended, all income becomes part of AEP, and any dividends paid must first come from AEP before tax-free distributions can be made from ORE. It is beneficial, therefore, for the corporation to reduce the AAA by the maximum extent possible during the post-termination period through dividend distributions, considering its cash position and borrowing ability. Otherwise, the AAA could be effectively "frozen" when it becomes ORE.

General Accounting Procedures

To illustrate accounting procedures, assume that management of Term Company, an S corporation with the same ownership structure as described earlier in the section on tracking separate retained earnings accounts, terminated its S corporation election on July 1, 20X6. The adjusted trial balance for the year 20X6 is presented in Exhibit 3-13. Note that retained earnings amounts are beginning-of-year amounts. It is assumed that the distributions of $200,000 were paid before September 15, 20X6, and that this amount was the largest possible reduction in the AAA based on the company's financial position. The company filed a short-year tax return as an S corporation on September 15, 20X5, covering the period January 1 through June 30, 20X6. It will file another short-year return as a conventional corporation on April 15, 20X7, for the period July 1 through December 31, 20X6. It made no additional distributions in 20X6.

Exhibit 3-13

Selected Accounts from Adjusted Trial Balance

TERM COMPANY
ADJUSTED TRIAL BALANCE
December 31, 20X6
(Selected Accounts Only)

	Debit	Credit
Retained earnings—AAA		$ 250,000
Retained earnings—AEP		200,000
ORE		90,000
Sales		2,000,000
Cost of goods sold	$ 1,200,000	
Operating expenses	580,000	
Federal income taxes	40,000	
Dividends	200,000	

* * *

The company did not close its books when it terminated its S corporation election, but it did calculate its taxable income through June 30, 20X6, to be $120,000. There are no tax/book differences for the year. Taxable income for the period July 1 to December 31 is $100,000. Therefore, income before taxes for the year is $220,000. Tax expense for the last half of the year is $40,000 (assume a 40% tax rate). Net income would thus be $180,000 ($120,000 + $100,000 − $40,000). The entry to allocate income to retained earnings is shown in Exhibit 3-14. Earnings after June 30, 20X6, are recorded as increases of AEP because they are taxable to the corporation.

Exhibit 3-14

Closing Entry to Allocate Income to Retained Earnings

	DR	CR
Income summary	$ 180,000	
Retained earnings—AAA		$ 120,000
Retained earnings—AEP (100,000 − 40,000)		60,000

* * *

Distributions, although after termination of S corporation status, are within the post-termination period, and thus are not distributions of the C corporation's earnings but instead reduce the AAA (unless the corporation elected the alternative method described above). Exhibit 3-15 illustrates the entry to record the distributions.

Exhibit 3-15

Entry to Record Distributions

	DR	CR
Retained earnings—AAA	$ 200,000	
Dividends		$ 200,000

* * *

An additional entry is needed as shown in Exhibit 3-16 to merge the undistributed portion of the AAA into ORE.

Exhibit 3-16

Entry to Merge AAA into ORE

	DR	CR
Retained earnings—AAA (250,000 + 120,000 − 200,000)	$ 170,000	
ORE		$ 170,000

* * *

Tax rules require that in subsequent years all distributions be allocated first to AEP. Consequently, pre-termination earnings that have been merged and reported as ORE cannot be distributed until all AEP is exhausted. In practice, however, it may be impossible to distribute AEP without impairing the financial condition of the company. Pretermination earnings of terminated S corporations may thus be effectively frozen.

Because federal tax rules view ORE as paid-in capital, a terminated S corporation may wish to transfer it to paid-in capital. State corporation law generally *permits* boards of directors to transfer retained earnings to paid-in capital but does not *require* such a transfer. If the board of directors of Term Company complies with state law and explicitly transfers ORE to paid-in capital, the accounting entry to record the transfer would be as shown in Exhibit 3-17. The resulting statement of retained earnings follows logically and is not illustrated. A note to the financial statements describing the transfer (not illustrated in this course) would normally be required to disclose the change in legal status to shareholders.

Exhibit 3-17

Entry to Transfer ORE to Paid-in Capital

	DR	CR
ORE	$ 260,000	
Additional paid-in capital from transfer of retained earnings		$ 260,000

* * *

A transfer of ORE to paid-in capital may give corporations less flexibility in managing its shareholders' equity because state corporation law generally places greater restrictions on paid-in capital than on retained earnings. Therefore, a terminated S corporation may choose not to make this transfer. If a transfer is not made, financial statements prepared in accordance with GAAP should continue to report pretermination earnings as ORE. Note disclosure would normally be required to inform shareholders that distributions from this item can be made tax free after other earnings have been distributed.

Tax/Book Differences and Termination

The procedures illustrated in the preceding paragraphs of this section illustrate how to account for AEP, AAA, and ORE in the event of termination of the S corporation election. If unreversed tax/book temporary differences exist, how should the TTA account be accounted for? It is a best practice to close the TTA account and transfer it to ORE. FASB ASC 740 requires the reinstatement of deferred tax assets and liabilities on existing differences.

COMPILATION AND REVIEW REPORTS FOR S CORPORATIONS

The only policy adopted by this course as uniquely applicable to S corporations is that the S corporation status be disclosed in the accountant's report parenthetically after the name of the company.

SELF-STUDY QUIZ

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

23. Which of the following statements best describes how tax/book differences from before an entity attained S corporation status affect retained earnings?

    a. The corporation's AAA and ORE are frozen.

    b. The balance of GAAP retained earnings is segregated into AEP, TTA, and/or ORE.

    c. Taxes deferred upon S corporation status will come due within a specific time period.

    d. Existing deferred tax assets and liabilities cannot be eliminated.

24. Which of the following could occur when a corporation terminates its S corporation election?

    a. Retained earnings items from income are combined with AAA.

    b. It must distribute all of its AAA by a certain time or it will be reclassified.

    c. All distributions during the termination period can be taxed as dividends and the basis of shares reduced appropriately.

    d. In subsequent years, the terminated S corporation should allocate distributions to AAA first.

SELF-STUDY ANSWERS

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

23. Which of the following statements best describes how tax/book differences from before an entity attained S corporation status affect retained earnings? **(Page 118)**

    a. The corporation's AAA and ORE are frozen. [This answer is incorrect. At the time of conversion to S status, AEP, as defined for tax purposes (not AAA or ORE) is frozen.]

    b. The balance of GAAP retained earnings is segregated into AEP, TTA, and/or ORE. [This answer is correct. The GAAP retained earnings balance can be segregated into two or more parts at the time a corporation converts to an S corporation: (1) AEP (as defined for tax purposes), (2) TTA (the net temporary differences), and (3) ORE (permanent differences, etc., that do not enter the calculation of AEP. These separate component accounts for retained earnings preserve the tax concept of AEP yet maintain a GAAP retained earnings balance.]

    c. Taxes deferred upon S corporation status will come due within a specific time period. [This answer is incorrect. Although the temporary differences originating before attaining S corporation status will reverse, they will not generate a tax liability so long as S corporation status is maintained. Thus, deferred taxes previously recorded will not become due.]

    d. Existing deferred tax assets and liabilities cannot be eliminated. [This answer is incorrect. FASB ASC 740 requires that existing deferred tax assets and liabilities be eliminated through a charge or credit to income tax expense for the period in which the enterprise ceases to be a taxable enterprise.]

24. Which of the following could occur when a corporation terminates its S corporation election? **(Page 119)**

    a. Retained earnings items from income are combined with AAA. [This answer is incorrect. When an S corporation election is terminated, it is necessary for financial accounting purposes to merge retained earnings items from income that has flowed through and been taxed to shareholders (AAA) with ORE. The merged retained earnings account should then be separated from retained earnings such as AEP that have resulted from earnings that were taxable to the corporation. However, the retained earnings items discussed would not have to be combined with AAA because they *are* AAA.]

    b. It must distribute all of its AAA by a certain time or it will be reclassified. [This answer is correct. When a corporation terminates its S corporation election, it has a specified period during which it can distribute all of the AAA. Any AAA *not* distributed becomes part of ORE.]

    c. All distributions during the termination period can be taxed as dividends and the basis of shares reduced appropriately. [This answer is incorrect. This treatment can be elected to avoid the accumulated earnings tax or the personal holding company tax. The company can have all of its distributions during this period taxed as dividends, but then the basis of the shares would *not* be reduced.]

    d. In subsequent years, the terminated S corporation should allocate distributions to AAA first. [This answer is incorrect. Tax rules require that in subsequent years all distributions be allocated first to AEP. Consequently, pre-termination earnings that have been merged and reported as ORE cannot be distributed until all AEP is exhausted.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Compilation and Review Engagements—Course 1 —Form and Presentation of Financial Statements, Partnerships, and S Corporations (CARTG171)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

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   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail).

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EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Compilation and Review Engagements—Course 1—Form and Presentation of Financial Statements, Partnerships, and S Corporations (CARTG171)

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

1. When would a table of contents be the most useful to readers of a financial statement presentation?

   a. The financial statements are consolidated.

   b. Supplementary information is included.

   c. It is a single-statement presentation.

   d. It is a set of basic financial statements.

2. Does authoritative guidance require an accountant's report to be printed on firm letterhead?

   a. Yes, this is a requirement under the SSARS to use letterhead.

   b. Yes, but there is an exception when certain software packages are used.

   c. No, but the report must be manually signed by the practitioner.

   d. No, but the use of letterhead is a best practice for professionalism.

3. After compiling her client's statements, Mary is preparing her accountant's report. Mary is a partner in a larger firm. Which of the following should she do?

   a. Title her report INDEPENDENT ACCOUNTANT'S REVIEW REPORT.

   b. Omit including an addressee since it is not an auditor's report.

   c. Include the city and state where Mary practices.

   d. Include a salutation, such as "Dear Gentlemen."

4. What is the correct term for when a balance sheet is presented on a single page with assets at the top and liabilities and stockholders' equity at the bottom?

   a. Account form.

   b. Report form.

   c. Multiple-step form.

   d. Single-step form.

5. Joe has a small business client. What type of comprehensive income would it be most likely to have (if any)?

   a. Equity securities accounted for under FASB ASC 320-10.

   b. Gains or losses related to postretirement benefits or pensions.

   c. Foreign currency translation adjustments.

   d. Small businesses are exempt from including comprehensive income in their financial statements.

6. Which of the following should be done if an entity uses a one-statement format to report comprehensive income?

   a. Two sections should be used: net income and other comprehensive income.

   b. The information about comprehensive income should immediately follow the income statement.

   c. The statement of income should be called the "Statement of Net Income."

   d. Tax effects should be aggregated, not broken down by each component of comprehensive income.

7. How is the statement of retained earnings or changes in stockholders' equity affected when the reporting entity's liabilities exceed its assets?

   a. It will combine its statement of income and retained earnings.

   b. It will report a negative equity balance, which requires specific captions.

   c. It will disclose changes in retained earnings on the face of its balance sheet.

   d. It will need to be treated as a departure from GAAP.

8. The basic financial statement that illustrates the changes in cash and cash equivalents during the reporting period is called what?

   a. Balance sheet.

   b. Statement of income.

   c. Statement of comprehensive income.

   d. Statement of cash flows.

9. Mac-2 receives cash receipts from the sale of its services. How would that be classified on Mac-2's statement of cash flows?

   a. Cash receipts from operating.

   b. Cash receipts from investing.

   c. Cash receipts from financing.

   d. Noncash investing and financing transactions.

10. Most cash flows are reported gross. Which of the following could be reported net instead?

    a. Proceeds from selling assets and cash payments for capital expenditures.

    b. Proceeds from long-term borrowings and repayments made on long-term obligations.

    c. Cash receipts and payments from selling and buying cash equivalents.

    d. Loans made by the entity and collections on loans.

11. To present its cash flows from operations, Pickletown starts with net income and then adjusts that amount for depreciation and other noncash items, and also accruals. This is an example of which of the following?

    a. The direct method.

    b. The indirect method.

    c. The cash method.

    d. The accrual method.

12. When reporting cash flows from investing activities, which of the following can be reported net instead of gross?

    a. Cash receipts.

    b. Cash payments.

    c. Long-term investments.

    d. Credit card receivables.

13. Which of the following should be included in the summary of significant accounting policies?

    a. Policies for which there is one acceptable alternative.

    b. Peculiarities based on the entity's industry.

    c. GAAP applications that are typical and reasonable.

    d. All accounting policies used, regardless of materiality.

14. Which of the following entities has correctly addressed an issue related to the financial statement notes?

    a. Northern Boundaries considers its notes supplemental information and does not include them in its financial statements.

    b. Southern Services has its accountant take responsibility for the notes since the practitioner prepared them.

    c. Western Wear presents its financial statement notes separately after its basic financial statements.

    d. Eastern Eateries copies disclosures into its notes for reference that were presented on the face of the financial statements.

15. Which of the following will occur when an entity chooses to include supplementary information in its financial statement presentation?

    a. GAAP information can be included in the supplementary information.

    b. Forecasts and projections will be considered supplementary information.

    c. The entity, not the CPA, must conceive of what supplementary information to include.

    d. The supplementary information will typically be presented separately from the basic statements.

16. Disclosures about which of the following risks and uncertainties is required?

    a. Risks and uncertainties related to the nature of the entity's operations.

    b. Risks and uncertainties related to management and key personnel.

    c. Risks and uncertainties related to deficiencies in the entity's internal control.

    d. Disclosure of all risks and uncertainties is required by GAAP.

17. When deciding whether it needs to use a certain significant estimate, Whammy Inc. determines that the possible future event the estimate is contingent on is more than slight but less than likely. Based the terminology in FASB ASC 450, this would be called which of the following?

    a. Probable.

    b. Reasonably possible.

    c. Unlikely.

    d. Remote.

18. A financial instrument with at least one underlying, at least one notional amount or payment provision, and no (or very low) initial net investment that allows net settlement is called what?

    a. An uncertainty.

    b. A derivative.

    c. A variable interest entity.

    d. A material financial instrument.

19. A small to midsized nonpublic company with accounts receivable should do which of the following?

    a. Only recognize losses that have already occurred and affected the entity's balance sheet.

    b. Separate individual receivables with special characteristics from all other receivables evaluated together.

    c. Make disclosures about credit risk considerations on an individual basis, not in groups.

    d. Make FASB ASC 310-10-50 disclosures related to short-term financing the entity provides to customers.

20. Which of the following is required of any company that wants to change its fiscal year?

    a. Proof of a natural year of business.

    b. Eliminating the necessity for a short tax year.

    c. A change in valuation allowance.

    d. Permission from the IRS Commissioner.

21. Which of the following relationships indicates that an entity is a variable interest entity (VIE)?

    a. The reporting entity helped to design the entity.

    b. At least half of the entity's activities are conducted on the reporting entity's behalf.

    c. The entity provides all of its own financial support.

    d. The entity's primary activities are related to earning a profit.

22. Which of the following statements best describes a situation related to a VIE?

    a. When debt is payable to a venture capitalist at more than the maximum level, sufficiency of equity is likely to exist.

    b. Companies and partnerships can be the primary beneficiary in a VIE, but individuals cannot.

    c. Determination of whether a VIE should be consolidated is important because different disclosures are required in each situation.

    d. The determination of whether an entity has the power to direct the significant activities of a VIE hinges on the definition of economic performance in FASB ASC 810.

23. What chance must an uncertain tax position have of being accepted by the IRS to be used in an entity's financial statements?

    a. Greater than 25%.

    b. Greater than 50%.

    c. Greater than 75%.

    d. Greater than 90%.

24. Consolidating financial statements would include columns for what information?

    a. Consolidated totals for both parent entities and subsidiaries.

    b. Parent company financial statements and subsidiary financial statements.

    c. Parent company financial statements, subsidiary financial statements, and consolidating entries.

    d. Parent company financial statements, subsidiary financial statements, consolidating entries, and balances for consolidated totals.

25. When would an accountant's report cover only consolidated information but not consolidating information?

    a. The consolidating information is included as supplemental information.

    b. The consolidating information is included on the face of the financial statements.

    c. Due to soft wording in GAAP, it is up to the professional judgment of the accountant.

    d. It depends on the unique facts and circumstances of each set of financial statements.

26. The price that an entity would receive if it sold an asset in an orderly transaction between appropriate market participants at a specific measurement date is called what?

    a. A controlling financial interest.

    b. The asset's fair value.

    c. A materiality judgment.

    d. A variable interest.

27. Which of the following characteristics indicates an *inactive market* for the fair value determination?

    a. Price quotes from current information.

    b. A decrease in liquidity risk premiums.

    c. A wide bid-ask spread.

    d. An abundance of publicly released information.

28. Based on applicable professional guidance, in what types of SSARS engagements must an accountant consider materiality?

    a. In reviews, but not in compilations or financial statement preparations.

    b. In compilations, but not in reviews or financial statement preparations.

    c. In compilations and reviews, but not in financial statement preparations.

    d. In financial statement preparations, compilations, and reviews.

29. Which of the following statements best describes an aspect of partnership taxation?

    a. Partnership income is taxed to the partners, so federal income tax expenses are omitted from the financial statements.

    b. A state-levied tax should be shown as an expense on the personal financial statements of each partner, not the partnership as a whole.

    c. The uncertainty and disclosure principles of FASB ASC 740-10 must be taken into account when preparing a partnership's tax return.

    d. Partnership financial statements are still presented in accordance with GAAP if they require income taxes be computed at a specific rate and included as an expense.

30. The Amicable Partnership makes salary payments to Mike, though he does little actual work for the partnership. How would they be accounted for?

    a. As an allocation of partnership income.

    b. As a partnership expense.

    c. As a loan.

    d. As a change in partnership interest.

31. Which of the following would be labeled "Partners' Capital" in partnership financial statements?

    a. Loans made from the partnership to partners.

    b. The statement of changes in partners' capital.

    c. The equity section of the partnership's balance sheet.

    d. Payments into a partnership retirement plan on behalf of partners.

32. Does the change to a partnership from a different type of business entity need to be made retroactively?

    a. Yes, retroactive change is needed because this is a change in accounting principle.

    b. Yes, retroactive change is required by FASB ASC 250-10.

    c. No, retroactive change is inappropriate unless needed to enhance comparability and adequately disclosed.

    d. No, because it is not a change in accounting principle, retroactive change is prohibited.

33. What is a disadvantage of operating as a limited liability company (LLC)?

    a. Only a specific number of members can be included.

    b. Tax laws can be different in each state.

    c. Members are exposed to double taxation—at both entity and personal levels.

    d. Only individuals can serve as members of LLCs.

34. What is the biggest advantage of operating as a limited liability partnership (LLP)?

    a. Applicable rules for pass-through taxation.

    b. LLPs are available in all states, while LLCs are not.

    c. LLPs provide members with more liability protection than LLCs.

    d. LLPs provide members less liability protection than a general partnership.

35. Where might an S corporation disclose changes in the components of its retained earnings?

    a. The balance sheet.

    b. The statement of retained earnings.

    c. The statement of income.

    d. The statement of cash flows.

36. If an S corporation pays taxes attributable to its owners, how are they accounted for?

    a. Using the provisions of FASB ASC 740.

    b. As a disclosure in the notes to the financial statements.

    c. As a transaction with the owners.

    d. As a dividend shown in the owners' financial statements.

37. Why is it a good idea for S corporations to maintain separate retained earning accounts in their books?

    a. Each account is required to have a separate caption and amount on the balance sheet.

    b. Separate accounts are usually needed to ensure proper tax accounting.

    c. The primary users of S corporation financial statements are third parties.

    d. Because they are included in accumulated earnings and profits.

38. S corporation losses passed through to shareholders are deductible to what extent?

    a. Their adjusted bases in the stock plus accumulated earnings and profits (AEP).

    b. Their share of AEP and other retained earnings (ORE).

    c. Their adjusted bases in the stock plus carryover amounts from previous years.

    d. Their adjusted bases in the stock plus debt due to them from the corporation.

39. Do S corporations need to record originating and reversing tax/book temporary differences?

    a. No, because they do not pay federal income tax.

    b. Yes, unless they report using a special purpose framework.

    c. Yes, because retained earnings accounts might be affected.

    d. Yes, because they have to pay that amount in federal income taxes.

40. Upon S corporation termination, why might the corporation decide to keep its ORE instead of transferring it to paid-in capital?

    a. Because it will have more flexibility for shareholders' equity under state law.

    b. Because such a transfer is not appropriate under GAAP.

    c. Because certain tax/book differences would not be reversed.

    d. Because the transfer would result in additional taxes for the former shareholders.

GLOSSARY

Account form: A side-by-side balance sheet presentation. Assets are presented on the left-hand side of the statement and liabilities and stockholders' equity on the right-hand side. It may be presented on two facing pages.

Accumulated adjustments account (AAA): An amount defined by federal tax regulations that reflects the aggregate amount of undistributed income and gains that have been taxed to the shareholders after 1982.

Accumulated earnings and profits (AEP): An amount defined by federal tax regulations that applies to S corporations with previous Subchapter C status. It generally does not apply to corporations that immediately elect S corporation status. AEP generally represents retained earnings that exist when S corporation status is attained, with certain adjustments required by the federal tax regulations.

Basic financial statements: The basic financial statements typically included in a GAAP financial statement presentation are the (1) balance sheet, (2) statement of income, (3) statement of comprehensive income, (4) statement of retained earnings or changes in stockholders' equity, and (5) statement of cash flows.

Cash: This includes more than currency on hand. It also includes demand deposits with banks or other financial institutions, as well as other kinds of accounts that have the general characteristics of demand deposits (i.e., the customer may deposit additional funds at any time and withdraw funds at any time without prior notice or penalty, such as money market accounts).

Cash equivalents: Short-term, highly liquid investments that (1) are readily convertible to known amounts of cash and (2) are near enough to maturity that any risk of changes in value due to changes in interest rates is insignificant (e.g., Treasury bills).

Combined financial statements: These are used when commonly controlled companies are likely to be more meaningful than their separate financial statements. Because none of the companies involved in these statements has an investment in the common stock of the other companies (like in consolidated/consolidating statements), the equity accounts of the various companies are combined rather than offset against the investment in subsidiaries held by the parent company.

Comprehensive income: This includes both net income and other comprehensive income (i.e., certain revenues, expenses, gains, and losses that are reported as separate components of stockholders' equity rather than net income).

Consolidated financial statements: Statements that combine a parent company's financial position and results of operations with those of its subsidiaries as if they were a single entity.

Consolidating financial statements: Statements that present the financial position and results of operations of the parent company and each of its subsidiaries in columnar form, together with columns that show eliminations of intercompany items and the consolidated totals.

Fair value: The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Financial instrument: Cash; evidence of ownership of an entity; or a contract that both (1) imposes on one entity a contractual obligation either (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity and (2) conveys to that second entity a contractual right either (a) to receive cash or another financial instrument from the first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity.

Derivative: A financial instrument or other contract with all of the following characteristics: (1) at least one underlying and one notional amount or payment provisions or both; (2) requires no initial net investment or an initial net investment lower than that required for other types of contracts expected to respond similarly to changes in market factors; and (3) terms that require or allow net settlement, can be readily settled net by a method outside the contract, or provides for delivery of an asset that puts the recipient in a position similar to net settlement.

Direct method: A method for presenting cash flow from operations that begins with cash receipts and deducts cash payments for operating costs and expenses, individually listing the cash effects of each major type of revenue and expense. The following categories of operating cash receipts and payments are required: (1) cash collected from customers, including lessees and licensees; (2) interest and dividends received; (3) other operating cash receipts, if any; (4) cash paid to employees and other suppliers of goods and services, including suppliers of insurance and advertising; (5) interest paid; (6) income taxes paid; and (7) other operating cash payments, if any.

Financing activities: Obtaining resources from owners and providing them with a return on, and a return of, their investment; borrowing money and repaying the amounts borrowed or otherwise settling the obligation; obtaining and paying for other resources from creditors on long-term credit. Receiving resources from donors with use stipulated for long-term purposes.

Indirect method: A method for presenting cash flow from operations that starts with net income and adjusts for (1) noncash items, such as depreciation and deferred income taxes, and (2) accruals.

Investing activities: Lending money, collecting on loans, acquiring and selling or disposing of securities, and acquiring and selling or disposing of productive assets that are expected to generate revenue over a long period of time.

Limited liability companies (LLCs): Business entities created under state law that are owned by members and combine many of the tax advantages of a partnership with the liability protection of a corporation. Each state establishes its own rules and characteristics for LLCs.

Limited liability partnerships (LLPs): These are a special type of general partnership that exists under state laws. Partners in an LLP are personally liable for the commercial or other obligations of the entity, their own acts and omissions, and the acts and omissions of people under their supervision. However, within this structure, LLP partners are not liable for acts and omissions by the other LLP partners or nonsupervised employees.

Near term: A period of time that does not exceed one years from the date of the financial statements.

Other retained earnings (ORE): Any amount that would be viewed as retained earnings under GAAP and state corporation law that is included in shareholders' bases for tax purposes, but is not included in the specific definitions of AAA, AEP, or TTA.

Partnership: An arrangement where two or more individuals share the liabilities and profits of a business venture. Different arrangements are possible, including limited partners and general partners. Such arrangements are usually governed by a partnership agreement.

Probable: A future event (or events) is likely to occur.

Reasonable possible: The chance of a future event (or events) occurring is more than remote, but less than likely.

Remote: There is only a slight chance of a future event (or events) occurring.

Running format: A running format presentation used for balance sheets in which assets appear at the top of the page and liabilities and stockholders' equity appear at the bottom. Generally, this presentation will appear on one page.

S corporation: A business entity that is similar to a C corporation, except that it provides liability protection and pass-through taxation to its members.

Severe impact: This is a significant financially disruptive effect on an entity's normal functioning. It is a higher threshold than material, but does include matters that are less than catastrophic.

Special purpose framework: Frameworks other than GAAP used to prepare financial statements, including the cash basis, the tax basis, the regulatory basis, the contractual basis, and other bases [i.e., other comprehensive bases of accounting (OCBOA)].

Substantive kick-out rights: The right for a limited partner to dissolve a limited partnership.

Summary of significant accounting policies: This is required by GAAP when financial statements that purport to present financial position (balance sheet), results of operations (statement of income), or cash flows (statement of cash flows) are issued. It identifies and describes the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, results of operations, or cash flows. This disclosure should encompass important judgments about the appropriateness of principles related to recognition of revenue and allocation of assets to future periods. It should describe accounting principles and methods that involve (1) a selection from existing acceptable alternatives, (2) industry peculiarities, and (3) unusual or innovative applications of GAAP.

Supplementary information: This is information that is not part of the basic financial statements and is not required for fair presentation in accordance with GAAP, though it is often useful to owners, management, or creditors (e.g., detailed schedules, summaries, comparisons, or statistical information).

Tax temporary adjustments (TTA): A term developed for this course to represent retained earnings changes that result when tax/book differences originate and then reverse. Such differences are not recognized for tax purposes in the AAA and AEP calculations. TTA are not viewed as part of shareholders' tax bases in their shares.

Variable interest: In a variable interest entity, this is a contractual, ownership, or other pecuniary interest in the entity that changes with fluctuations in the fair value of the entity's net assets.

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COMPANION TO PPC'S GUIDE TO COMPILATION AND REVIEW ENGAGEMENTS

COURSE 2

ENGAGEMENT ADMINISTRATION (CARTG172)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses engagement administration for compilation and review engagements. The two lessons cover a variety of topics, including whether the SSARS apply to a particular engagement, engagement letters, workpaper documentation, practice issues, and independence issues.
PUBLICATION/REVISION DATE:	July 2017
RECOMMENDED FOR:	Users of *PPC's Guide to Compilation and Review Engagements*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of accounting
CPE CREDIT:	6 NASBA Registry "QAS Self-Study" Hours This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.
FIELD OF STUDY:	Accounting
EXPIRATION DATE:	Postmark by **July 31, 2018**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Issues Related to the Administration of Compilation and Review Engagements, Part I

Completion of this lesson will enable you to:
- Identify general principles for SSARS engagements, important considerations for acceptance and continuance, and when SSARS apply to an engagement.
- Determine what levels of service is appropriate in different situations, what is needed in an engagement letter, and how to handle changes in the type of engagement after the engagement has begun.
- Recognize how to handle subsequent events and the subsequent discovery of existing facts, what types of workpaper documentation are needed, and when it is appropriate to withdraw from an engagement.

Lesson 2—Issues Related to the Administration of Compilation and Review Engagements, Part II

Completion of this lesson will enable you to:
- Determine what communications are needed between predecessor and successor accountants and how to deal with common practice issues in compilation and review engagements.
- Identify the requirements for quality control, peer review, and ethics standards when a firm performs compilation and review engagements.

- Identify the ways accounting software can be used and how to deal with independence issues, consultation, and differences of opinion.

TO COMPLETE THIS LEARNING PROCESS:

Submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

- Email to: *CPLGrading@thomsonreuters.com*
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See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Issues Related to the Administration of Compilation and Review Engagements, Part I

INTRODUCTION

This course discusses a variety of topics related to engagement administration for firms that perform compilation and review engagements. Lesson 1 begins with a discussion of generation principles that apply to engagements performed under the Statements on Standards for Accounting and Review Services (SSARS), such as relevant ethical requirements and how to conduct the engagement.

Next, this lesson discusses client acceptance and continuance, as well as how to determine whether SSARS apply to a particular engagement. This is followed by a discussion about recommending a level of service to clients, including an examination of the needs of various financial statement users and alternatives to full disclosure GAAP financial statements.

That is followed by a discussion of engagement letters broken down between those for compilation engagements, review engagements, when reporting on specified elements, and when reporting on pro forma information.

Next appears a discussion of changes in the type of engagement after the engagement begins, subsequent events, and the subsequent discovery of facts that existed at the date of the report.

Finally, Lesson 1 concludes with a discussion of workpaper documentation and when it is appropriate to withdraw from an engagement.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify general principles for SSARS engagements, important considerations for acceptance and continuance, and when SSARS apply to an engagement.
- Determine what levels of service is appropriate in different situations, what is needed in an engagement letter, and how to handle changes in the type of engagement after the engagement has begun.
- Recognize how to handle subsequent events and the subsequent discovery of existing facts, what types of workpaper documentation are needed, and when it is appropriate to withdraw from an engagement.

GENERAL PRINCIPLES THAT APPLY TO SSARS ENGAGEMENTS

AR-C 60, *General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services*, provides general principles for engagements performed in accordance with the Statements on Standards for Accounting and Review Services (SSARS) and is intended to help accountants understand their professional responsibilities when performing SSARS engagements. AR-C 60 addresses the following general principles:

- Financial statements.
- Ethical requirements.
- Professional judgment.
- Conduct of the engagement in accordance with SSARS.
- Engagement level quality control.
- Acceptance and continuance of client relationships and engagements.

Financial Statements

According to AR-C 60.04, the financial statements subject to the SSARS engagement are the entity's. That paragraph also clarifies that SSARS do not impose responsibilities on management; in addition, SSARS do not override laws and regulations that govern management's responsibilities.

Ethical Requirements

AR-C 60.08 requires accountants to comply with all relevant ethical requirements when performing a SSARS engagement. Such ethical requirements include the fundamental principles of professional ethics as described in the AICPA *Code of Professional Conduct* (Code), and include principles relating to a member's responsibilities; the need to serve the public interest while maintaining integrity and objectivity; and the responsibility to perform the procedures with due care.

QC 10.21, *A Firm's System of Quality Control*, describes a firm's responsibilities to establish and maintain a quality control system for all SSARS engagements, including policies and procedures designed to provide the firm with reasonable assurance that the firm and its personnel will comply with relevant ethical requirements. Lesson 2 discusses ethical requirements in more detail and provides additional guidance on a system of quality control that provides reasonable assurance that the firm complies with such requirements.

Professional Judgment

AR-C 60.09 requires the accountant to exercise professional judgment throughout the SSARS engagement.

AR-C 60.A17–.A21 contain additional guidance that may be useful in understanding how critical the exercise of professional judgment is to the performance of an engagement in accordance with SSARS. For instance, accountants use professional judgment when interpreting which ethical and legal requirements are relevant in a particular engagement. They also use it when making the many informed decisions required throughout that engagement. Only an accountant who has the appropriate training, knowledge, and experience can exercise professional judgment when making reasonable judgments and informed decisions about matters affecting the engagement. If difficult or contentious issues arise during the course of the engagement, consultations among engagement team members or others within or outside the firm also assist the accountant in making informed and reasonable judgments.

Exercising professional judgment in an individual engagement is based on the accountant's knowledge of the facts and circumstances, including—

- knowledge acquired during engagements performed in prior periods;
- the accountant's understanding of the entity and the industry in which it operates, its environment, its accounting system, and the application of its financial reporting framework; and
- the extent to which the exercise of judgment by either management or the accountant is required when preparing and presenting the financial statements.

Conduct of the Engagement in Accordance with SSARS

AR-C 60.10 states that an accountant must perform an engagement to review, compile, or prepare financial statements in accordance with SSARS. This involves the following:

- *Complying with Each Requirement within All Relevant AR-C Sections.* An AR-C section is relevant to the engagement when it is in effect and the circumstances addressed in it exist. (If a particular requirement is not relevant in a specific engagement because it is conditional and the condition does not exist, the accountant does not have to comply with it.)
- *Understanding the Entire Text of a Relevant AR-C Section.* This includes understanding the related application and other explanatory material to enable the accountant to properly apply the AR-C sections' requirements and to satisfy the objectives of the relevant sections.

Defining Professional Responsibilities in SSARS. AR-C 60.15 uses two specific terms to describe the degree of responsibility accountants have in complying with professional requirements:

- *Unconditional Requirements* An accountant must always comply with an unconditional requirement if it is relevant to the engagement. SSARS use the word *must* to indicate an unconditional requirement.

- *Presumptively Mandatory Requirements* An accountant must comply with a presumptively mandatory requirement if it is relevant to the engagement, except in rare situations discussed in AR-C 60.16. SSARS use the word *should* to indicate a presumptively mandatory requirement.

If an AR-C section requires an accountant to consider whether a specific procedure should be performed or action taken, that procedure or action is presumptively mandatory. The accountant should determine whether to perform the procedure or action based on the accountant's consideration and professional judgment.

AR-C 60.16 discusses the rare situations in which an accountant may determine that it is necessary to depart from a relevant presumptively mandatory requirement. Typically, these situations only arise when the requirement is for a specific procedure to be performed and, in the specific circumstances of the engagement, the accountant determines that the procedure would be ineffective in achieving the intent of the requirement. In such situations, the accountant is required to perform alternative procedures designed to accomplish the intent of the requirement.

In addition, when the accountant departs from the relevant, presumptively mandatory requirement, AR-C 60.17 (added by SSARS No. 23) says the accountant must document both of the following:

- The justification for the departure.

- How the alternative procedures performed accomplished the intent of the requirement.

Relevant Interpretive Publications and Other Preparation, Compilation, and Review Publications. When performing a financial statement preparation engagement, AR-C 60.18 also states that the accountant should *consider* other relevant interpretive publications. While interpretive publications are not SSARS, they are issued under the authority of ARSC and present recommendations on how to apply SSARS in specific circumstances.

In addition, AR-C 60.19 requires accountants to assess the relevance of other preparation, compilation, and review publications to the circumstances of the engagement. While these publications have no authoritative status, they may assist the accountant in understanding and applying the SSARS.

CLIENT ACCEPTANCE AND CONTINUANCE FOR COMPILATION AND REVIEW ENGAGEMENTS

Statement on Quality Control No. 8, *A Firm's System of Quality Control* (QC 10), CPA firms to establish policies and procedures for the acceptance and continuance of client relationships and specific engagements. According to QC 10.27, the policies and procedures should be designed to provide reasonable assurance that the firm will undertake or continue relationships and engagements only when the firm—

a. possesses the competence and capabilities to perform the engagement, including the necessary time and resources, to do so;

b. complies with applicable legal and ethical requirements; and

c. considers the client's integrity and does not discover information that indicates a lack of integrity by the client.

AR-C 60.25–.26 provide guidance related to the accountant's responsibility with regard to the acceptance or continuance of client relationships and engagements performed under the SSARS. AR-C 60.A46 indicates that considerations related to client acceptance and continuance and compliance with relevant ethical requirements occur throughout the engagement as conditions and changes in circumstances occur. The accountant's performance of procedures on engagement acceptance and continuance and evaluation of relevant ethical requirements at the beginning of the engagement affect the accountant's decisions and actions before other significant procedures are performed.

In today's environment, many lawsuits involving CPA firms occur because the firm associates with clients that lack integrity. CPA firms are often faced with difficult client acceptance and continuance decisions. On the one hand, since competition for clients is great, there is pressure to accept and continue relationships with all clients, even marginal ones. On the other hand, most firms recognize that scarce resources (such as personnel) should be dedicated to serving clients that are both profitable and unlikely to subject the firm to litigation risk.

For accounting firms, exposure to risk is often caused by poor decision-making about which clients to accept and keep. Faced with the opposing pressures of intense competition and the need to increase profitability while decreasing the risk of legal exposure, all firms—regardless of their size or the nature of their practice—can benefit from (and, as noted above, are required to establish) a formalized system to evaluate client acceptance and continuance.

One of the key factors in managing risk is understanding the risk associated with a new client or engagement before accepting the work. That understanding is essential for firms to determine whether the client relationship will be cost-beneficial. If the client is accepted, that advance understanding of the client also helps the firm properly assess the impact of risk on the engagement and the related procedures that may be necessary.

This section assists firms in making more informed client acceptance and continuance decisions and discusses some of the unique considerations when evaluating client acceptance and continuance in SSARS engagements.

Evaluating Firm Competence, Capabilities, and Resources

Deciding whether to accept or continue an engagement requires policies and procedures that guide the firm to determine whether it has personnel who possess the competence and capabilities and have scheduling availability to provide the desired services. QC 10.A11 offers the following matters to consider:

- Do firm members have, or are they able to acquire, the requisite industry or subject matter knowledge?
- Do firm members have, or are they able to acquire, the requisite experience with regulatory or reporting requirements?
- Are there sufficient competent and capable firm personnel available to staff the engagement?
- If specialists are needed, are they available?
- For applicable engagements, are there individuals qualified to perform an engagement quality control review?
- Can the firm meet the reporting deadline required by the engagement?

If the CPA firm believes that there is an integrity issue with a prospective client, it is a best practice for the firm not to associate itself with the client's financial statements or the client.

Compliance With Legal and Ethical Requirements

Another component when deciding whether to accept or continue an engagement requires the firm to develop policies and procedures to determine whether the firm can comply with the requisite legal and ethical requirements of the engagement.

Legal and Regulatory Requirements. Certain engagements may require a firm to comply with specific legal and regulatory requirements. Those requirements may apply as a result of the type of industry in which the client operates. For example, engagements that require the CPA to collect and examine the personal information of a client's customers, employees, or vendors may subject the accountant to federal and state privacy laws such as the

Health Insurance Portability and Accountability Act (HIPAA) and the Gramm-Leach-Bliley Act. Also, many companies may be subject to Security Breach Notification Laws, which are in effect in a significant number of states.

Ethical Requirements. ET 0.300.050 of the Code requires that members in public practice be independent in fact and appearance, as well as maintain integrity and objectivity when performing professional services. In cases where it appears that a firm's independence, integrity, or objectivity is likely to be impaired, the firm should decline to accept an engagement. AR-C 60.25a states that the accountant should not accept a SSARS engagement if he or she will not be able to comply with relevant ethical requirements. A discussion of independence issues related to compilation and review engagements, including a discussion of the effects of accounting/write-up services on independence, and a discussion of the Code appear in Lesson 2.

Prospective Client's Integrity

Quality control standards also require CPA firms to establish policies and procedures to consider the client's integrity. SSARS engagements are typically performed for small businesses. One of the characteristics of a small business is concentration of ownership or operational control in one or a few individuals. This means that a primary consideration in client acceptance and continuance for a SSARS engagement is the general honesty and good faith of the owner/manager. However, the client includes various individuals such as the principal owners, key management, related parties, and those charged with governance. Consequently, it is a good idea to consider the integrity of any individuals who have more than just a passing involvement with the business; for example, spouses of owners who are active in the business should be included in the evaluation. AR-C 60.25c states that the accountant should not accept a SSARS engagement if there is reason to believe doubts about management's integrity would affect the engagement.

Factors to Consider When Evaluating Integrity. When evaluating the integrity of the client, QC 10.A12 offers the following factors to consider:

- Both the identity and business reputation of the client's principal owners, key management, and those charged with its governance.
- Nature of operations and specific business practices of the client.
- Attitude of the client's principal owners, key management, and those charged with governance towards aggressive accounting and internal control matters.
- Inappropriate client limitation regarding the scope of work.
- Indications of the client's possible involvement in money laundering or other criminal activities.
- Reasons for the proposed appointment of the firm and dismissal of the previous firm.
- Length of the relationship with the client.

Sources of Information. There are no specific requirements in professional literature on the depth of an investigation of a client. However, sources of information may include—

a. Discussions with other CPAs in the community and other professionals—lawyers, bankers, etc.

b. Specific inquiry of the prospective client's lawyer and banker.

c. Inquiry of commercial credit agencies and business groups or associations, such as the Better Business Bureau.

d. Review of the prospective client's most recent interim or annual financial statements, income tax returns, and reports to regulatory agencies.

e. Specific inquiry of any former accountants who have provided services to the client. Lesson 2 discusses communications between predecessor and successor accountants in detail.

f. A background check performed by an investigative firm.

Continuing Clients

For continuing clients, consider whether there are any significant changes in the following matters that would cause the firm to discontinue serving the client:

- Nature of the business,
- Ownership,
- Management,
- Issues involving client integrity,
- Financial condition,
- Earnings pressures,
- Conditions or events or operating results that are relevant to the going-concern assumption,
- Loan covenant compliance,
- Litigation status,
- Control environment or activities,
- Fraud risks,
- Management attitude toward, or pressures on, the accountants,
- Scope of the engagement,
- Other internal or external conditions, and
- Changes in independence.

Availability and Reliability of Information

AR-C 60.25b states that the accountant should not accept a SSARS engagement if his or her preliminary assessment of the engagement indicates that the information needed to perform the engagement will not be available or may be unreliable. The preliminary assessment should be documented.

Significant Issues Discovered in the Acceptance or Continuance Process

If issues involving the acceptance or continuance of a client relationship or a specific engagement are identified and the firm decides to accept or continue the client relationship or the specific engagement, QC 10 requires that the firm document how the issues were resolved.

DETERMINING WHETHER THE SSARS WILL APPLY TO A PARTICULAR ENGAGEMENT

Because the SSARS establish specific performance and communication requirements for preparation, compilation, and review engagements, it is necessary for the accountant to recognize when his or her services are governed by it.

Scope of the SSARS

Generally, any engagement for a *nonpublic entity* that involves *unaudited financial statements* is within the scope of the SSARS.

One exception to the basic scope of the SSARS is included in AR-C 90.02 and applies to reviews of nonpublic entity interim financial information when all of the following conditions are met:

a. The entity's most recent annual financial statements have been audited by the accountant or a predecessor accountant.

b. The accountant either has been engaged to audit the entity's current year financial statements, or when it is expected that the current year financial statements will be audited, the appointment of another accountant to audit the current year financial statements is not effective prior to the period covered by the review.

c. The entity prepares its interim financial information using the same financial reporting framework as that used to prepare its annual financial statements.

In these instances, the accountant should perform the interim reviews in accordance with AU-C 930, *Interim Financial Information*. *PPC's Guide to Audits of Nonpublic Companies* discusses AU-C 930 reviews.

Accounting Services

Over the last few years, many accounting firms' nonattest services practices have significantly grown in both fees and volume by providing firm employees who function as staff accountants, bookkeepers, controllers, and CFOs by performing various accounting services for the firm's clients. This growth is being driven by the following:

- Highly regulated industries need employees who know the regulations.

- Small businesses need employees who can perform multiple roles. Employees who excel at all of the tasks that are required of them are rare.

- Many small business owners do not have tremendous financial acumen.

- Clients have needed these services.

- The internet has allowed these services to be more easily provided remotely.

Much of the growth is from internal referrals. The firm often gives up the attest service engagement and performs the nonattest services, rather than trying to maintain their independence. The nonattest services are usually long term services that provide more value to the clients than the attest service would. The bulk of this work is generally done at the client location, but it may be provided through online services such as cloud computing. In many instances, the accountants become part of the management team. Many of these services are provided to nonprofit organizations, but may also be provided to credit unions, community banks, agricultural businesses, manufacturing/distribution companies, construction contractors, health care services, IT consultants, law firms, and dealerships.

In some instances, the accounting firm will do both the nonattest service and the attest service for a client. However, special precautions should be taken to ensure that independence is maintained. Nonattest services tend to be more cost effective, generate higher gross revenue, and may provide (or be perceived to provide) more value to the clients than attest services. Although the gross margin is lower, the net is usually higher. The contracts that the accounting firms have with their clients for these nonattest services are usually month-to-month contracts; however, the relationships are usually long term. Clients who terminate the relationship are usually those who outgrow the need for such services and bring the work in house.

Examples of such services are as follows:

a. Preparing financial statements.

b. Performing merger and acquisition evaluations.

c. Preparing a working trial balance.

d. Processing payroll.

e. Assisting in adjusting the books of account.

f. Doing budgeting and forecasting.

g. Consulting on accounting, tax, and similar matters.

h. Serving as *de facto* board members.

i. Preparing tax returns.

j. Developing and maintaining banking relationships.

k. Providing various manual or automated bookkeeping or data processing services.

l. Helping with 401(k) plans.

m. Processing financial data for clients of other accounting firms.

n. Monitoring key business metrics.

The following paragraphs provide further discussion on a few of these accounting services.

Preparing a Working Trial Balance. In the course of providing accounting services to a client, the accountant sometimes supplies the client with a working trial balance. Though the provisions of the SSARS generally apply when the accountant prepares financial statements, they do not necessarily apply when the accountant prepares a trial balance. The Appendix at AR-C 70.A21 can assist accountants in determining whether the accountant is preparing financial statements or assisting in preparing financial statements. For example, the Appendix makes it clear that preparing or proposing adjustments, or entering general ledger transactions or processing payments in the accounting software system, do not make the accountant subject to the SSARS. The question then is, "How do you determine if a presentation is a financial statement or a trial balance?" Some of the attributes that help distinguish a trial balance from a financial statement are summarized as follows:

a. Financial statements group general ledger accounts to create single line items within the financial statement. Trial balances do not.

b. Financial statements include totals and subtotals such as current assets, total assets, total current liabilities, total liabilities, total equity, revenues, operating income, and net income. Trial balances do not.

c. Contra accounts, such as an allowance for bad debts, are netted against the related primary accounts in financial statements. In trial balances, they are not.

d. Financial statement titles generally reflect financial position, results of operations, or cash flows. Trial balance titles ordinarily include the term *trial balance* or indicate that the presentation is a listing of accounts.

e. Financial statements have numerous mathematical relationships. For example, total assets are equal to liabilities plus equity. The only mathematical relationship in trial balances is that total debits equal total credits.

f. Financial statements present assets and liabilities based on their liquidity and maturity. Trial balances present accounts based on their account number order.

g. Financial statements reflect results of operations, and net income is closed to retained earnings. Trial balances do not reflect results of operations, and the retained earnings balance is the balance as of the beginning of the period.

Tax Returns as Financial Statements. Financial presentations included in tax returns would not be considered financial statements according to the definition of *financial statements* in the SSARS. Thus, the fact that a tax return is subsequently used for a purpose other than submission to taxing authorities does not affect its exemption from the SSARS (AR-C 60.07 and AR-C 90.05). In addition to income tax returns, information returns, such as Form 990 and Form 5500, are considered tax returns for purposes of the SSARS. The accountant is not precluded from complying with a request from a client to issue a compilation or review report on financial information contained in a tax return.

In some states, boards of accountancy rules may require that Form 990 and other tax returns used in lieu of financial statements be accompanied by a compilation report. If the accountant chooses to accept such an engagement, the accountant may follow the SSARS performance requirements to compile the financial information contained in the tax return and issue a compilation report.

Medicare/Medicaid Cost Reports as Financial Statements. Different ARSC committees have informally reached different conclusions at various times (and practice varies) as to whether third party reimbursement reports are subject to SSARS. This course suggests that Medicare/Medicaid cost reports would not be considered financial statements. Therefore, such reports would not be governed by SSARS. Third party reimbursement reports are a government-required submission of financial and nonfinancial information, not financial statements. Those reports are signed by the client under penalties of perjury. The accountant may be engaged by the client to prepare the reports or to assist the client with report preparation similar to an engagement involving a tax return. Consequently, it seems logical that the guidance pertaining to tax returns, as discussed above, would also apply here.

Providing Automated Accounting Services without Preparing Financial Statements. As stated earlier, many accountants derive significant fees from providing automated accounting services to their clients. These services, often called write-up services, may include such items as the following:

- Recording cash receipts and disbursements, accruals, and adjustments to produce a general ledger or trial balance.
- Maintaining accounts receivable or accounts payable ledgers.
- Calculating depreciation and maintaining fixed asset registers.
- Processing payrolls.
- Calculating payroll tax deposits.
- Preparing payroll tax returns.
- Summarizing data required for tax returns.

As long as the accounting services do not include financial statements, the services are not included within the scope of the SSARS. The Appendix at AR-C 70.A21 lists maintaining depreciation schedules' preparing or proposing adjusting journal entries, and providing bookkeeping services as examples of services which are not financial statement preparation services and therefore not subject to AR-C 70. Further guidance on write-up services can be found in *PPC's Guide to Write-up Services*. To order call (800) 431-9025 or access **tax.thomsonreuters.com**.

Engagement Driven

The SSARS are is *engagement driven*. In other words, SSARS apply when an accountant in public practice is engaged to prepare, compile, or review the financial statements of a nonpublic entity. The SSARS may also be adapted to other historical or prospective financial information. Does this mean the accountant can provide the client with financial statements and not have to comply with the requirements of AR-C 70, *Preparation of Financial Statements*, as long as they are not engaged to do so? AR-C 70 says the determination of whether the accountant has been engaged to prepare the financial statements or to simply assist in preparing the financial statements is based on the services requested by the client and is a matter of professional judgment. The Appendix at AR-C 70.A21 can assist accountants in determining whether the accountant is preparing financial statements or assisting in preparing financial statements. It is a best practice that accountants not provide their clients with financial statements unless engaged to do so. As discussed in Lesson 2, bookkeeping services can subject a firm to litigation risk. Engagement letters are one way to help manage litigation risk as they indicate the services which the accountant will provide. Due to these risk factors, it is not a good idea to prepare and provide financial statements to a client without complying with the requirements of AR-C 70.

Specified Elements, Accounts, or Items of a Financial Statement

The SSARS address specified elements by saying that SSARS apply when the accountant is engaged to prepare, compile, or review an entity's financial statements; but may be adapted to other historical financial information. The application guidance at AR-C 70.A3, AR-C 80.A3, and AR-C 90.A2 lists specified elements, accounts, or items of a financial statement as other historical information.

SELF-STUDY QUIZ

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

1. Which of the following is a general principle that affects engagements performed under the Statements on Standards for Accounting and Review Services (SSARS)?

    a. SSARS impose responsibilities on both management and the accountant during this type of engagement.

    b. If the accountant has complied with SSARS, he or she is exempt from requirements in the AICPA *Code of Professional Conduct*.

    c. The use of professional judgment is critical when performing an engagement under the SSARS.

    d. When performing a financial statement preparation engagement, consulting interpretive guidance other than the SSARS themselves is prohibited.

2. A firm should only accept or continue engagements under what circumstance?

    a. The firm needs the engagement to meet its bottom line.

    b. The client has complied with applicable legal and ethical requirements.

    c. Information provided by the firm seems credible.

    d. The firm has no information to indicate a lack of integrity in the client.

3. An engagement involving which of the following would generally fall within the scope of the SSARS?

    a. A public company.

    b. Unaudited financial statements.

    c. Interim financial information.

    d. Nonattest accounting services.

4. Which of the following is true of a trial balance?

    a. It groups general ledger accounts to create single line items.

    b. It includes totals and subtotals such as current assets and net income.

    c. The title will generally reflect financial position or cash flows.

    d. It reflects the retained earnings balance as that from the beginning of the period.

SELF-STUDY ANSWERS

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

1. Which of the following is a general principle that affects engagements performed under the Statements on Standards for Accounting and Review Services (SSARS)? **(Page 148)**

   a. SSARS impose responsibilities on both management and the accountant during this type of engagement. [This answer is incorrect. According to AR-C 60.04, the financial statements subject to the SSARS engagement are the entity's. That paragraph also clarifies that SSARS do *not* impose responsibilities on management; in addition, SSARS do not override laws and regulations that govern management's responsibilities.]

   b. If the accountant has complied with SSARS, he or she is exempt from requirements in the AICPA *Code of Professional Conduct*. [This answer is incorrect. AR-C 60.04 requires accountants to comply with all relevant ethical requirements when performing a SSARS engagement. Such ethical requirements include the fundamental principles of professional ethics as described in the AICPA *Code of Professional Conduct*.]

   c. The use of professional judgment is critical when performing an engagement under the SSARS. [This answer is correct. AR-C 60.09 requires the accountant to exercise professional judgment throughout the SSARS engagement. AR-C 60.A17–.A21 contain additional guidance that may be useful in understanding how critical the exercise of professional judgment is to the performance of an engagement in accordance with SSARS. Only an accountant who has the appropriate training, knowledge, and experience can exercise professional judgment when making reasonable judgments and informed decisions about matters affecting the engagement.]

   d. When performing a financial statement preparation engagement, consulting interpretive guidance other than the SSARS themselves is prohibited. [This answer is incorrect. When performing a financial statement preparation engagement, AR-C 60.18 states that the accountant should consider other relevant interpretive publications. While interpretive publications are not SSARS, they are issued under the authority of ARSC and present recommendations on how to apply SSARS in specific circumstances.]

2. A firm should only accept or continue engagements under what circumstance? **(Page 149)**

   a. The firm needs the engagement to meet its bottom line. [This answer is incorrect. According to QC 10.27, one criteria that should be met before a firm makes its acceptance or continuance decision is that the firm is competent to perform the engagement, including the necessary time and resources, to do so. Therefore, having the competency and capability to perform an engagement should be more important than a firm's bottom line when making this decision.]

   b. The client has complied with applicable legal and ethical requirements. [This answer is incorrect. While it is important for the client to comply with applicable legal and ethical requirements, this is something that the firm will gather information about while performing the engagement. Prior to making the acceptance or continuance decision, QC 10.27 says that the *firm* must be able to comply with applicable legal and ethical requirements.]

   c. Information provided by the firm seems credible. [This answer is incorrect. Under QC 10.27, the firm needs to have actively considered the client's integrity before making an acceptance or continuance decision. Accepting the engagement because information from the firm appears to be credible would not meet the requirements of QC 10.]

   d. The firm has no information to indicate a lack of integrity in the client. [This answer is correct. According to QC 10.27, the policies and procedures for client acceptance and continuance should be designed to provide a firm with reasonable assurance that it will undertake or continue relationships and engagements only when the firm (among other things) does not discover information that indicates a lack of integrity by the client.]

3. An engagement involving which of the following would generally fall within the scope of the SSARS? **(Page 153)**

   a. A public company. [This answer is incorrect. Engagements that fall under SSARS generally involve *nonpublic* companies.]

   b. Unaudited financial statements. [This answer is correct. Generally, any engagement for a *nonpublic company* that involves *unaudited financial statements* is within the scope of the SSARS.]

   c. Interim financial information. [This answer is incorrect. If interim financial information meets the conditions outlined in AR-C 90.02, the engagement may fall under SSARS; however, those specific requirements must be met. Merely being concerned with interim financial information is not enough, on its own, to subject an engagement to SSARS.]

   d. Nonattest accounting services. [This answer is incorrect. Nonattest accounting services will affect a firm's ability to perform engagements under SSARS, but all such engagements are not subject to SSARS themselves.]

4. Which of the following is true of a trial balance? **(Page 154)**

   a. It groups general ledger accounts to create single line items. [This answer is incorrect. *Financial statements* group general ledger accounts to create single line items within the financial statement. Trial balances do not.]

   b. It includes totals and subtotals such as current assets and net income. [This answer is incorrect. *Financial statements* include totals and subtotals such as current assets, total assets, total current liabilities, total equity, revenues, operating income, and net income. Trial balances do not.]

   c. The title will generally reflect financial position or cash flows. [This answer is incorrect. *Financial statement* titles generally reflect financial position, results of operations, or cash flows. Trial balance titles ordinarily include the term *trial balance* or indicate that the presentation is a listing of accounts.]

   d. It reflects the retained earnings balance as that from the beginning of the period. [This answer is correct. Financial statements reflect the results of operations, and net income is closed to retained earnings. Trial balances do not reflect the results of operations, and the retained earnings balance is the balance as of the beginning of the period.]

RECOMMENDING A LEVEL OF SERVICE TO THE CLIENT

When clients need financial statements as part of an engagement, accountants may want to discuss certain engagement alternatives with their clients. For instance, unless a third-party user has specified either the level of service (preparation, compilation, or review) or the type of financial statements (with or without disclosures, GAAP or tax basis, etc.), clients may be able to select among several acceptable options. For example, they might engage the accountants to compile financial statements that omit substantially all disclosures, or they might ask them to prepare financial statements that conform to the cash basis of accounting. Generally, both of those options would result in lower costs than a compilation of full disclosure, GAAP financial statements. Of course, a review of financial statements generally will always be more costly than a compilation or preparation of financial statements. Given the cost variations, accountants should consider carefully the client's needs and the expected benefits of the service before suggesting a level of service.

The following paragraphs provide guidance on issues that might impact the accountants' recommendations about a level of service such as—

- Needs of users,
- Need for comparative financial statements,
- Alternatives to full disclosure GAAP financial statements,
- Independence, and
- Commissions, referral fees, and contingent fees.

Needs of Users

Most unaudited financial statements of nonpublic entities are prepared for one of three groups of users: management, owners, and banks or other creditors. The appropriate level of assurance for each user will, of course, vary with the circumstances. However, three generalizations can be made:

a. Financial statements prepared following the guidance in AR-C 70 will usually be sufficient for management.

b. Owners who are not active in management probably prefer reviewed statements at least annually.

c. Banks and other creditors usually want as much assurance as they can get.

Needs of Management. When the financial statements are intended for management use, helping the client determine the best level of service is basically a matter of proper communication. The client tells the CPA what he thinks he wants; the CPA explains the differences in procedures, communications, and costs; the client asks the CPA for his view; the client selects the level of service. The accountant may be engaged to prepare financial statements and not report on those financial statements by following the guidance in AR-C 70. In addition, clients can select among a number of alternative types of presentations. For instance, they might be able to choose between one or more of the alternatives to full disclosure GAAP financial statements discussed below.

Needs of External Users. When banks or other creditors are involved, what is best for the client often becomes secondary to what is best for the creditor. In many cases, the CPA will be able to save the client unnecessary fees by properly explaining the differences between prepared, compiled, reviewed, and audited financial statements to the banker. When recommending a level of service, accountants also should keep in mind that they may be able to tailor the engagement to meet creditor needs. For instance, a banker whose loan is collateralized by accounts receivable may request an audit because he wants accounts receivable confirmed. However, if explained properly, the banker might accept reviewed financial statements or an agreed-upon procedures report (performed in accordance with SSAE No. 18) on accounts receivable. Another option would be to issue a compilation report on accounts receivable. All of these alternatives would undoubtedly save the client money. Q&A 9150.18 of the AICPA Technical Questions and Answers provides guidance in situations where a bank has requested that a CPA compile the balance sheet of another (nonclient) entity.

In other cases, the level of service to be performed is specified by an external user other than a bank or creditor. Certain state regulations, for instance, require common interest realty associations (CIRAs) to submit audited financial statements to applicable state regulatory authorities. Other states require that CIRAs submit reviewed statements. Are accountants responsible for determining the required level of service? The best answer to this question is, "Absolutely not." Management is responsible for determining what level of service is required and engaging the accountants to perform that service. However, if the accountants become aware that the planned level of service does not meet relevant legal, regulatory, or contractual requirements, it is a best practice for the accountants to inform the client and suggest this communication to be made in writing. If done orally, it is suggested that the discussion be documented in the engagement workpapers.

Need for Comparative Financial Statements

Presenting financial statements in comparative form with prior period financial statements generally enhances their usefulness. However, reporting on comparative financial statements can be somewhat complicated. Changes in level of service (i.e., 20X1 reviewed/20X2 compiled), and changes in accountants can create reporting problems that the accountant should evaluate before recommending comparative financial statements to his client.

AR-C 90.A86 states that the level of information for prior periods is comparable with the current period financial statements in comparative financial statements. The AICPA Guide, paragraph 2.54, states that financial statements that omit disclosures are not comparable to a period that includes disclosures. The SSARS allow substantially all disclosures to be omitted only for prepared or compiled financial statements. Thus, if the prior period financial statements were compiled and omitted substantially all disclosures, accountants have only two options for reporting on comparative financial statements that include the prior period statements:

a. Compile the current period financial statements and omit substantially all disclosures.

b. Recompile the prior period financial statements to include disclosures.

These considerations should also be evaluated before recommending a level of service (or setting a fee).

Alternatives to Full Disclosure GAAP Financial Statements

Clients need timely, accurate financial information to assist them in making business decisions. Some accountants believe that compiled GAAP financial statements are often not a cost-effective means of meeting a client's needs. Consequently, CPAs should examine the various alternatives to full disclosure GAAP financial statements. The following paragraphs include some of the alternatives currently available.

Providing Monthly Reports Containing Only Selected Financial or Operational Information. In some cases, clients may not need financial statements every month in order to make the decisions necessary to run their businesses. Instead, they may only need selected or summarized financial or operational information. This information may consist of account balances, such as sales, cash, or accounts receivables, operating information, such as labor utilization, average ticket per customer, number of units produced or sold, or a combination of both. As long as such information does not constitute a financial statement, SSARS do not apply.

Preparing or Compiling Financial Statements That Omit Substantially All Disclosures. If a client does not feel that full disclosure statements are cost-effective, then the CPA may prepare or compile financial statements that omit substantially all of the disclosures required by GAAP or are ordinarily included in special purpose framework financial statements. The report should be modified to alert users to the lack of disclosures. The SSARS do allow accountants a nonreporting option if the guidance in AR-C 70 is followed. For AR-C 70 engagements, the omission of disclosures should be disclosed in the financial statements.

Compiling Special Purpose Framework Financial Statements. Many accountants find relief from some of the GAAP measurement and disclosure requirements by preparing financial statements using a financial reporting framework other than GAAP. In many cases, these financial statements will be less complex and require less time. For example, consider the preparation of cash-basis interim financial statements that omit substantially all disclosures. The financial statements should be relatively easy to prepare (that is, the accountant need only be concerned with *cash in* and *cash out*). The accountant's report generally would not change from period to period since only items representing departures from the cash basis would have to be disclosed in the report and such departures would be rare.

Compiling Financial Statements That Have Measurement Departures. Clients often do not consider it cost-effective to spend the time to adjust certain account balances (such as inventory, the accounts receivable allowance, depreciation expense, or deferred taxes), particularly in their interim financial statements. If a SSARS report is issued, all material departures should be listed in the report. Therefore, the report should state that the financial statements contain GAAP measurement departures, include a reference to the departures, and state that the effects of the departures have not been determined. (Note that the dollar effects of GAAP departures on the financial statements are only required to be disclosed in the report if they have been determined by management or are known as a result of the accountant's procedures.)

Some practitioners are concerned that this causes them to spend undue time listing departures in their report that (a) the client is already aware of and (b) are related to adjustments that the client has already determined to be unnecessary for its purposes. The rationale for disclosing the departures, however, is that there may be, and often are, users of the financial statements who would otherwise be unaware of the departures.

Many firms are able to minimize the time necessary to compile financial statements that have measurement departures by having standardized reports for interim financial statements that contain recurring measurement departures. Such reports are particularly effective when the client's financial statements have the same departures from one interim period to the next, which is often the case. For example, consider the situation where a client decides to accrue for bonuses only at year end and not at interim periods. In that situation, the CPA may draft, in advance, pro forma interim compilation reports listing the planned GAAP departure. This report may then be used for all interim periods.

Another important point to remember is that FASB ASC 270-10 permits the use of certain estimates in the preparation of interim financial statements. Consequently, even if the client can only reasonably estimate certain amounts in its interim financial statements, that may not constitute a material measurement departure, and disclosure in the accountant's report may not be necessary.

Independence

The only type of report a CPA can issue on financial statements when he or she is not independent is a compilation report. If the client needs reviewed financial statements, the CPA who is not independent should not perform the review service and might recommend another CPA to provide the review service. For many small businesses, the accountant serves as a primary business consultant and may unknowingly be providing services as part of the compilation or review engagement that impair his or her independence. Therefore, it is important for CPAs to understand the various rules and regulations that govern independence. A discussion of the authoritative literature relating to independence and examples of client services or situations that might impair an accountant's independence are provided in Lesson 2.

ENGAGEMENT LETTERS FOR SSARS ENGAGEMENTS

Introduction

An engagement letter is required for all SSARS engagements.

Engagement Letters for Financial Statement Preparation Engagements

AR-C 70.10 requires the accountant to agree upon the terms of the engagement with management or those charged with governance, as appropriate. The agreed-upon terms of the engagement should be documented in an engagement letter or other suitable form of written agreement, be signed by both the accountant or accountant's firm and management or those charged with governance, and include the following:

a. Objective of the engagement.

b. Responsibilities of management, as noted in AR-C 60.26c.

c. Management's agreement that each page of the financial statements will include a statement indicating that no assurance is provided on the financial statements. (If that statement is not included, the accountant is required to issue a disclaimer that makes clear that no assurance is provided on the financial statements, or perform a compilation engagement instead of a financial statement preparation engagement, or withdraw from the engagement.)

d. The responsibilities of the accountant.

e. Limitations of the engagement.

f. Identification of the applicable financial reporting framework to be used to prepare the financial statements.

g. Whether the financial statements are to (1) contain a known departure from the applicable financial reporting framework (including inadequate disclosure) or (2) omit substantially all disclosures required by the applicable financial reporting framework.

As mentioned above, one of the preconditions in AR-C 60 to accepting a preparation engagement is that the accountant obtain management's agreement that it acknowledges and understands its responsibility for the SSARS preparation engagement. In a financial statement preparation engagement, management should acknowledge and accept it responsibility for the following:

a. Selecting the financial reporting framework to be used in preparing the financial statements.

b. Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error.

c. Preventing and detecting fraud.

d. Ensuring that the entity complies with applicable laws and regulations.

e. Ensuring the accuracy and completeness of records, documents, explanations, and other information, including significant judgments, that management provides for the preparation of the financial statements.

f. Providing the accountant with—

  (1) access to all information that is relevant to the preparation and fair presentation of the financial statements, including records, documents, and other matters;

  (2) additional information that the accountant may request from management for the purpose of the preparation engagement; and

  (3) unrestricted access to individuals within the entity of whom the accountant decides to ask questions.

Engagement Letters for Compilation Engagements

AR-C 80.10–.11 requires the accountant to obtain and document a written agreement with the client regarding the services to be performed. The understanding with the client should be signed by both the accountant or the accountant's firm and management or those charged with governance and should include the following:

- The objectives of the engagement.

- The responsibilities of management, including management's responsibilities for—

  •• the selection of the applicable financial reporting framework to be applied in the preparation of the financial statements that are free from material misstatement, whether due to fraud or error.

  •• the preparation and fair presentation of financial statements in accordance with the applicable financial reporting framework and the inclusion of all informative disclosures that are appropriate for the applicable financial reporting framework.

- the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements.
- the prevention and detection of fraud.
- ensuring that the company complies with the laws and regulations applicable to its activities.
- the accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, provided to the accountant during the engagement.
- providing the accountant with:
  - access to all information of which management is aware is relevant to the preparation and fair presentation of the financial statements.
  - additional information that may be requested by the accountant for the purpose of the compilation engagement.
  - unrestricted access to persons within the entity of whom the accountant determines it necessary to make inquiries.
- including the accountant's compilation report in any document containing financial statements that indicate that the entity's accountant has performed a compilation engagement on such financial statements.

- The responsibilities of the accountant.
- The limitations of the compilation engagement.
- Identification of the applicable financial reporting framework to be used in the preparation of the financial statements.
- The expected form and content of the accountant's compilation report and a statement that there may be circumstances in which the actual report may differ from expectations.

Engagement Letters for Review Engagements

AR-C 90.11–.12 requires the accountant to obtain a written agreement with the client regarding the services to be performed. The understanding with the client should be signed by both the accountant or the accountant's firm and management or those charged with governance, and should include the following:

- The objectives of the engagement.
- The responsibilities of management, including management's responsibilities for—
  - the selection of the applicable financial reporting framework to be applied in the preparation of the financial statements.
  - the preparation and fair presentation of financial statements in accordance with the applicable financial reporting framework and the inclusion of all informative disclosures that are appropriate for the applicable financial reporting framework.
  - the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements.
  - the prevention and detection of fraud.

- •• ensuring that the entity complies with the laws and regulations applicable to its activities.
- •• the accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, provided to the accountant during the engagement.
- •• providing the accountant with:
  - access to all information of which management is aware is relevant to the preparation and fair presentation of the financial statements.
  - additional information that may be requested by the accountant for the purpose of the review engagement.
  - unrestricted access to persons within the entity of whom the accountant determines it necessary to make inquiries.
- •• providing the accountant, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.
- •• including the accountant's review report in any document containing financial statements that indicate that the entity's accountant has performed a review engagement on such financial statements.

- The responsibilities of the accountant.
- The limitations of the review engagement.
- Identification of the applicable financial reporting framework to be used in the preparation of the financial statements.
- The expected form and content of the accountant's review report and a statement that there may be circumstances in which the actual report may differ from expectations.

Engagement Letters When Reporting on Specified Elements

The SSARS says that they may be adapted for and applied to engagements related to other historical or prospective financial information. Specified elements, accounts, or items of a financial statement are listed as examples of other historical financial information to which SSARS may be applied.

Engagement letters can be adapted and used to document the understanding with the entity when the accountant is engaged to compile one or more specified elements, accounts, or items of a financial statement.

Period Covered by the Engagement Letter

When accountants document their understanding with the client via an engagement letter, do they need to obtain a new letter every year? Although the SSARS do not address that issue specifically, many accountants meet with their clients and update their engagement understandings at least annually. Doing so and documenting the understanding in an engagement letter ensures that it (a) reflects the scope of services the accountants are currently providing and (b) contains all legal protection clauses available to the accountants. Additionally, the Observations and Suggestions at Paragraphs 1.32 and 2.21 of the AICPA Guide reiterate that it is best practice to obtain an engagement letter at least annually.

Using Engagement Letters to Minimize Liability

If an accountant does not comply with the SSARS in a financial statement preparation, compilation, or review engagement, a client may be successful in recovering damages suffered based on the accountant's actions under contract or tort law. According to tort law concepts, the client may be successful in suing the accountant if he can establish fraud, constructive fraud, or negligence.

One way to minimize liability is through the engagement letter. The engagement letter is an invaluable loss prevention/loss mitigation measure. When a dispute arises between the accountant and the client regarding services for which the client has contracted, the burden of proof is on the accountant to prove that the agreement was for a lower service (compilation and review), not an audit. A signed engagement letter serves as documentation that the client understood the level of service to be provided by the CPA.

Much of the language included in engagement letters (such as the illustrative sections included in this course) is written to minimize the CPA's liability in compilation and review engagements. For example, the illustrative engagement letters contain the following sentence:

> Our engagement cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by error or fraud, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations.

This sentence clarifies the accountants' extremely limited responsibility for detecting fraud in a SSARS engagement.

In the illustrative review engagement letters, that same paragraph goes onto say:

> However, we will inform the appropriate level of management of any material errors and any evidence or information that comes to our attention during the performance of our review procedures that indicates fraud may have occurred. In addition, we will inform you of any evidence or information that comes to our attention during the performance of our review procedures regarding noncompliance with laws and regulations that may have occurred, unless they are clearly inconsequential.

This additional language clarifies the accountants' responsibility for communicating errors, fraud, and noncompliance with laws and regulations to their clients. Specifically, accountants agree to inform their clients of all material errors or fraud that come to their attention during the course of their engagement, and they agree to communicate only noncompliance with laws and regulations that come to their attention if they are considered consequential. In other words, accountants have no responsibility to communicate noncompliance with laws and regulations that is consider to be clearly inconsequential. The term *clearly inconsequential* appears to refer to an amount that is so obviously immaterial that its insignificance cannot be questioned. However, it is a best practice for accountants to consider more than the quantitative amounts involved since some acts or occurrences may indicate a potential for other noncompliance with laws and regulations. In summary, the accountant is not required to communicate clearly inconsequential matters, but if there is doubt about the consequence of a matter, it is a good idea for that information to be communicated.

The illustrative engagement letters for reviews also contain language that clarifies the accountants' responsibility for internal control while describing the review service:

> A review engagement does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents; or other procedures ordinarily performed in an audit engagement.

Using the guidance in ET 1.228.010 of the Code, "Indemnification of a Covered Member," and in the SSARS, the accountant may include a clause such as the following in a SSARS engagement letter:

> You agree to hold us harmless and to release, indemnify, and defend us from any liability and costs, including attorney's fees, resulting from management's knowing misrepresentations to us.

This clause is acceptable and will not impair independence, provided that it is restricted to "knowing misrepresentations." However, if the indemnification clause includes *any* misrepresentation, which includes negligent misrepresentations, the CPA firm's independence would be impaired and the firm could not issue a review report but may issue a compilation report, provided that the lack of independence is properly disclosed.

The AICPA Professional Ethics Executive Committee (PEEC) issued ET 1.400.060, "Indemnification and Limitation of Liability Provisions," of the AICPA *Code of Professional Conduct* to remind practitioners that some regulators (including the SEC) prohibit the use of indemnification and limitation of liability provisions. Failure to comply with a regulator's requirements on the use of indemnification and limitation of liability provisions is considered an act discreditable to the profession.

Additional Engagement Letter Provisions for Limiting a Firm's Liability

There are a number of additional provisions that CPAs may want to add to their engagement letters. The use of some of these provisions is becoming common. They can be very effective at limiting a firm's legal liability and assisting a firm to resolve client disputes in a cost-effective manner. Those additional provisions are discussed in the following paragraphs.

It is a best practice for accountants to consult their legal counsel and insurance carrier when assessing language in the engagement letter intended to limit exposure to legal liability.

Undertaking-to-be-truthful Clauses. An engagement letter clause that can be helpful in litigation is an agreement by the client to be truthful, accurate, and complete in making representations to the firm. The following are examples of this type of clause:

> You acknowledge that as a condition of our agreement to perform a review, you agree to the best of your knowledge and belief to be truthful, accurate, and complete in the representations you make to us during the course of the review and in the written representations provided to us at the completion of the review.

or

> You acknowledge that as a condition of our agreement to perform a compilation, you agree to the best of your knowledge and belief to be truthful, accurate, and complete in the representations you make to us during the course of the compilation.

If a client brings an action against a CPA firm alleging malpractice and breach of contract, in some states the firm would be able to defend the breach of contract claim if the client had breached its duty to provide truthful, accurate, and complete representation. This defense could be asserted at the outset of the litigation via a motion to dismiss. In some states, a misrepresentation, however, would not necessarily provide a defense to the client's malpractice claim unless it could be shown that the client's misrepresentation actually interfered with the firm's performance of its procedures. This defense, however, would probably not be successful on a motion and would have to be asserted at trial.

A representation letter obtained from the client at the end of the review may not be regarded as a substitute for an undertaking-to-be-truthful clause in the engagement letter. The engagement might be terminated before a representation letter is obtained and the client's attorney might argue a representation letter was not a condition of the engagement.

Alternative Dispute Resolution. Alternative dispute resolution (ADR) is a popular way of attempting to resolve client disputes without exposing the firm to the cost and uncertainty of litigation. ADR generally takes less time than litigation and provides a better chance of preserving the client/accountant relationship. ADR techniques apply primarily to client disputes (for example, fee disputes) rather than third-party claims because the engagement letter is a two-party contract and does not bind third-party users.

Arbitration closely resembles litigation and is usually presided over by a panel comprised of one or more persons who may or may not be attorneys. Many CPA firms prefer to have an arbitration panel include at least one CPA. In an arbitration, the parties present their respective cases to an arbitrator (or panel of arbitrators) who renders a verdict at the conclusion of the case. The arbitrator acts as both judge and jury by making evidentiary rulings, ordering discovery, and imposing sanctions in addition to deciding the issues in the case.

While arbitration may sometimes represent an attractive alternative to litigation, it has some significant drawbacks. First, arbitrators sometimes tend to simply split the difference between the two parties' claims. Second, there is no guarantee that a client who does not like the arbitrator's decision cannot have it overturned in court. Third, and most importantly, a firm's agreement, without the consent of its insurance carrier, to submit to binding arbitration may limit the insurer's ability to defend the case and void the firm's insurance coverage for that claim. Before adding language regarding arbitration or other alternative dispute resolution methods to engagement letters, accountants may consult with their attorney and obtain a written consent from their insurance carrier.

Another well-known ADR technique is mediation. While mediation is often discussed along with arbitration, it is a vastly different process. In mediation, no resolution is imposed on the disputing parties by a neutral party. Instead, mediation is little more than voluntary settlement negotiations facilitated by a neutral party. If mediation works, it can be an expeditious and cost effective way of resolving disputes.

Mediation frequently succeeds when direct bilateral negotiations between the parties fail. Mediation has certain advantages:

- The parties are brought into the settlement discussions so they can hear first-hand (not through their attorneys) the strengths and weaknesses of their opponent's case.
- The discussion takes place in a controlled atmosphere that prevents the parties from storming out of the discussions at the first sign of disagreement.
- Mediations are not about winning or losing, but rather about finding a resolution that is better than the result likely to be achieved through litigation.
- By communicating through the mediator, the parties are able to reach compromises that are not possible where neither party is willing to blink first for fear of showing weakness.

Because mediation is about reaching agreement and because the parties spend little time together in face-to-face meetings, there is an opportunity for the parties to resolve their differences without feeling that they have to reveal their strengths and weaknesses to the other party.

The principal weakness of mediation is that it does not always resolve the claim. The following language can be inserted into an engagement letter to provide for use of an alternative dispute resolution method in cases where there is a dispute with a client. (This provision is based on one developed by BDO Seidman for its own use. It has been used with permission.)

> If any dispute, controversy, or claim arises, either party may, upon written notice to the other party, request that the matter be mediated. Such mediation will be conducted by a mediator appointed by and pursuant to the Rules of the American Arbitration Association or such other neutral facilitator acceptable to both parties. Both parties will exert their best efforts to discuss with each other in good faith their respective positions in an attempt to finally resolve such dispute or controversy.
>
> Each party may disclose any facts to the other party or to the mediator which it, in good faith, considers necessary to resolve the matter. All such discussions, however, will be for the purpose of assisting in settlement efforts and will not be admissible in any subsequent litigation against the disclosing party. Except as agreed by both parties, the mediator will keep confidential all information disclosed during negotiations. The mediator may not act as a witness for either party in any subsequent arbitration between the parties.
>
> The mediation proceedings will conclude within sixty days from receipt of the written notice unless extended or terminated sooner by mutual consent. Each party will be responsible for its own expenses. The fees and expenses of the mediator, if any, will be borne equally by the parties.
>
> If any dispute, controversy, or claim cannot be resolved by mediation, then the dispute, controversy, or claim will be settled by arbitration in accordance with the Rules of the American Arbitration Association (AAA) for the Resolution of Accounting Firm Disputes. No prehearing discovery will be permitted unless specifically authorized by the arbitration panel. The arbitration hearings will take place in the city closest to the place where this agreement was performed in which the AAA maintains an office, unless the parties agree to a different locale.

> The award issued by the arbitration panel may be confirmed in a judgment by any federal or state court of competent jurisdiction. All reasonable costs of both parties, as determined by the arbitrators, including (1) the fees and expenses of the AAA and the arbitrators and (2) the costs, including reasonable attorneys' fees, necessary to confirm the award in court, will be borne entirely by the non-prevailing party (to be designated by the arbitration panel in the award) and may not be allocated between the parties by the arbitration panel.
>
> Such arbitration shall be binding and final. In agreeing to arbitration, we both acknowledge that in the event of a dispute over fees charged by the accountant, each of us is giving up the right to have the dispute decided in a court of law before a judge or jury and instead we are accepting the use of arbitration for resolution.

Specifying a Time Limitation. Some CPA firms have attempted to limit their liability exposure by including a provision requiring that all claims, with respect to services, be asserted within a specified period of time, such as one year from the date the subject services were performed. This limitation provision may protect the firm from a substantial portion of claims arising out of fraud as well as frivolous counter-claims in the event that the firm is required to sue a client for unpaid professional fees. A sample of this provision follows:

> Because there are inherent difficulties in recalling or preserving information as the period after an engagement increases, you agree that, notwithstanding the statute of limitations of the State of [Fill in client's state of domicile.], any claim based on this engagement must be filed within [12] months after performance of our service, unless you have previously provided us with a written notice of a specific defect in our services that forms the basis of the claim.

Clients are likely to resist this clause and the firm will need to balance the length of the statute of limitations, when the statute begins to run, and the type of services performed against the use of this provision.

Considerations When Using Engagement Letter Clauses. If a CPA firm wishes to utilize any of the preceding clauses to limit its liability, the firm should consult its legal counsel and its insurance carrier. In addition, it is important that the client take note of the clauses before signing and returning the engagement letter. Otherwise, there is a danger that the courts may be unwilling to enforce the provisions. This means the CPA firm either point out such clauses to the client when the engagement letter is delivered or type such clauses in bold print and/or capital letters so that they will stand out from the remainder of the engagement letter.

Informing Clients of Outsourcing Arrangements

It seems to be rare for accounting firms to outsource portions of compilation or review engagements. However, firms often will outsource other services which might be covered by their compilation or review engagement letter, such as tax services. ET 1.150.040 of the Code requires that clients be informed, preferably in writing, if the practitioner's firm will outsource professional services to third-party service providers. If the practitioner intends to use third-party service providers (that is, entities not controlled or employed by the accounting firm), the client should be informed before confidential client information is shared with the service provider. Also, ET 1.700.040 of the AICPA Code requires a contractual agreement between the accounting firm and the service provider to maintain the confidentiality of client information. The contractual agreement should provide the accounting firm with reasonable assurance that the service provider has procedures in place to prevent the unauthorized release of confidential information. If the firm does not have a contractual agreement with the service provider, the firm should obtain specific consent from the client before disclosing confidential information to the service provider.

In cases where the practitioner chooses to provide written disclosure that a third-party service provider will be used, the following paragraph may be included in the engagement letter.

> We may from time to time, and depending on the circumstances, use third-party service providers in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable

precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third-party service provider. Furthermore, we will remain responsible for the work provided by any such third-party service providers.

CHANGES IN THE TYPE OF ENGAGEMENT AFTER IT HAS COMMENCED

Occasionally, during the course of a financial statement engagement (audit, review, or compilation), the CPA may be requested by the client to change the nature of the engagement. The request may be either for a *step-up* in the level of service, e.g., compilation to review, review to audit, or a *step-down* in the level of service, e.g., audit to review, review to compilation. A change in the type of engagement may also involve a compilation with disclosures to a compilation without disclosures.

Step-ups

The SSARS do not specifically address step-ups. Although a change to a higher level of service is always voluntary, it harbors no dangers for the CPA as long as the engagement is completed according to the standards appropriate for the eventual level of service agreed upon. With this in mind, the CPA should (a) determine what additional procedures and standards are required for the level of service requested, (b) determine whether it is possible and practical to perform the procedures and comply with the standards, and (c) revise the understanding of the engagement if the type of service is changed.

Step-down from Audit or Review or Compilation to Review or Compilation or Preparation

AR-C 90.A138 and paragraph 2.90 of the AICPA Guide: *Preparation, Compilation, and Review Engagements* (AICPA Guide) list three reasons that might cause a client to request a change in the level of service after an audit or review engagement has begun:

a. A change in circumstances affecting the entity's requirement for an audit or review.

b. A misunderstanding as to the nature of an audit or review, or the alternative review and compilation services originally available.

c. A restriction on the scope of the audit or review, whether imposed by the client or caused by circumstances.

Occasionally, the requirement for audited or reviewed or compiled statements is removed after an engagement begins. For example, an audit of an interim period started as a result of acquisition negotiations is aborted when the negotiations collapse, or a line-of-credit is reduced to a level that no longer requires audited or reviewed financial statements under the bank's policy. Agreeing to a step-down in the level of service is generally acceptable in such circumstances.

A misunderstanding of the nature of the various services available is also an acceptable reason for a step-down in level of service. However, misunderstandings can cause other problems (particularly fee problems), and the CPA should try to avoid them. Every practitioner should make audit clients aware of the limited assurance report (review report), the nonassurance report (compilation report), the financial statement preparation non-reporting option, and reexamine the reasons for the engagement before the engagement begins.

The implications of a restriction on the scope of the audit or review should be considered carefully, including the possibility that information affected by the scope restriction may be incorrect, incomplete, or otherwise unsatisfactory. If the accountant has such concerns after considering the circumstances of the scope restriction, he should not agree to issue a report based on a lower level of service. AU-C 210.17 includes auditor's responsibilities when it is determined there is no reasonable justification for a change in the terms of an audit engagement or if the auditor is not permitted to continue the audit engagement.

AR-C 90.90 ordinarily precludes an accountant from agreeing to a step-down from an audit when the accountant has been prohibited from corresponding with the entity's legal counsel for purposes of obtaining evidence on litigation, claims, and assessments. And, although written representations are not specifically addressed in the SSARS step-down discussion, AR-C 90.37 says the accountant should withdraw from the engagement if management does not provide the required representations. Consequently, a step-down would not be appropriate.

AR-C 90.87 states that, regardless of the reason for the request for a step-down from an audit, the accountant should consider the propriety of a step-down if the cost to complete the audit is relatively insignificant.

If, after considering the circumstances, the accountant agrees to a step-down from an audit or review to a compilation or review, he should follow the guidance in AR-C 90.89 and paragraph 2.95 of the AICPA Guide when drafting the accountant's report. The accountant is precluded from making reference in the report to the following items:

a. The original engagement.

b. Any audit or review procedures that may have been performed.

c. Scope limitations that resulted in the changed engagement.

Step-downs to financial statement preparation engagements are not specifically addressed in the SSARS in the AICPA Guide. However, it seems likely that such a step-down may be acceptable in certain situations and that the guidance listed earlier in this section.

Step-down from Full Disclosure to Omission of Substantially All Disclosures

A step-down in the level of service might involve a request that substantially all disclosures be omitted. The accountant can agree to such a request only if, to the best of the accountant's knowledge, the omission of disclosures is not intended to mislead those who might reasonably be expected to use the statements. Since it is inappropriate to issue reviewed statements that omit substantially all disclosures, the accountant should explain to the client that the accountant will not be able to issue a review report (express limited assurance), even if the engagement included inquiry and analytical procedures.

When a CPA receives a request to step-down to statements that omit substantially all disclosures, the CPA should not only seek to ascertain whether the omission is undertaken with the intention of misleading, but also *document* any findings before agreeing to compile such statements. If such statements were, in fact, misleading and the accountant were sued, failure to follow up on a clue such as the client's request for a step-down in service could likely be damaging.

SELF-STUDY QUIZ

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

5. Jerry is preparing financial statements for the management of Whammy Inc. What level of service would typically be sufficient to meet management's needs?

   a. Statements prepared under AR-C 70.

   b. Statements reviewed annually.

   c. An agreed-upon procedures report.

   d. As much assurance as possible.

6. Which technique would allow accountants to improve the usefulness of the financial statements?

   a. Providing comparative financial statements.

   b. Providing GAAP financial statements with full disclosures.

   c. Foregoing independence when providing a review report.

7. When included in a SSARS engagement letter, which of the following could help a CPA mount a defense against a breach of contract claim?

   a. Alternative dispute resolution (ADR).

   b. A statement about the auditor's responsibility for detecting fraud.

   c. A hold harmless clause.

   d. An undertaking-to-be-truthful clause.

8. Under what circumstances would a step-down in services immediately cause a CPA to withdraw from the engagement?

   a. There was a misunderstanding about the nature of the original services.

   b. The client prohibits the CPA from corresponding with legal counsel about current litigation.

   c. The requirement for an audit was removed.

   d. The scope of an audit is limited by circumstances beyond the client's control.

SELF-STUDY ANSWERS

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

5. Jerry is preparing financial statements for the management of Whammy Inc. What level of service would typically be sufficient to meet management's needs? **(Page 160)**

   a. **Statements prepared under AR-C 70. [This answer is correct. The appropriate level of assurance for the different types of users varies with the circumstances. However, one rule of thumb is that financial statements prepared following the guidance in AR-C 70 will usually be sufficient for management. When the financial statements are intended for management use, helping the client determine the best level of service is basically a matter of proper communication. Therefore, Jerry needs to communicate with the management of Whammy Inc. to confirm that the typical type of financial statements will work for their needs.]**

   b. Statements reviewed annually. [This answer is incorrect. Owners who are not active in management are the user type who will typically prefer seeing reviewed statements at least annually. Management would not need this type of engagement, so Jerry may be able to direct his client to a different level of service.]

   c. An agreed-upon procedures report. [This answer is incorrect. When banks or other creditors are involved, what is best for the client often becomes secondary to what is best for the creditor. When recommending a level of service, accountants should also keep in mind that they may be able to tailor the engagement to meet creditor needs. For instance, a banker whose loan is collateralized by account receivable may request an audit because he wants accounts receivable confirmed. However, if explained properly, the banker might accept reviewed financial statements or an agreed-upon procedures report (performed in accordance with SSAE No. 18). However, because Jerry's engagement is focused on the needs of Whammy Inc.'s management instead of a third-party, the recommendations for level of service will be different.]

   d. As much assurance as possible. [This answer is incorrect. One general rule of thumb when selecting the appropriate level of service for each type of financial statement user is that banks and other creditors usually want as much assurance as they can get. Management, however, will not need as much assurance, so Jerry may suggest a different level of service to the management of Whammy Inc. for this engagement.]

6. Which technique would allow accountants to improve the usefulness of the financial statements? **(Page 154)**

   a. **Providing comparative financial statements. [This answer is correct. Presenting financial statements in comparative form with prior period financial statements generally enhances their usefulness. However, reporting on comparative financial statements can be somewhat complicated. Therefore, this is not likely to save time in the compilation or review process.]**

   b. Providing GAAP financial statements with full disclosures. [This answer is incorrect. This type of financial statement presentation includes the most detail, which means it will take the most time to produce. Accountants who need to provide the financial statements more quickly will need to figure out a different method.]

   c. Foregoing independence when providing a review report. [This answer is incorrect. The only type of report a CPA can issue on financial statements when he or she is not independent is a compilation report. If the client needs reviewed financial statements, the CPA who is not independent should not perform the review service and might recommend another CPA to provide the review service. Therefore, doing the review to save time would not be in line with professional guidance.]

7. When included in a SSARS engagement letter, which of the following could help a CPA mount a defense against a breach of contract claim? **(Page 167)**

   a. Alternative dispute resolution (ADR). [This answer is incorrect. ADR is a popular way of attempting to resolve client disputes without exposing the firm to the cost and uncertainty of litigation. However, an engagement letter clause calling for the use of ADR will not be specifically helpful for breach of contract claims.]

b. A statement about the auditor's responsibility for detecting fraud. [This answer is incorrect. Engagement letters may include a sentence that says, "Our engagement cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by error or fraud, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations." This sentence clarifies the accountants' extremely limited responsibility for detecting fraud. However, including this sentence will not specifically help defend against a breach of contract claim.]

c. A hold harmless clause. [This answer is incorrect. Using the guidance in ET 1.228.010 of the Code, "Indemnification of a Covered Member," and in the SSARS, the accountant may include a clause such as the following in a SSARS engagement letter: "You agree to hold us harmless and to release, indemnify, and defend us from any liability and costs, including attorney's fees, resulting from management's knowing misrepresentations to us." This clause is acceptable and will not impair independence, provided that it is restricted to "knowing misrepresentations." However, this clause cannot specifically be used as a defense against breach of contract claims.]

d. An undertaking-to-be-truthful clause. [This answer is correct. An engagement letter clause that can be helpful in litigation is an agreement by the client to be truthful, accurate, and complete in making representations to the firm. If a client brings an action against a CPA firm alleging malpractice and breach of contract, in some states the firm would be able to defend the breach of contract claim if the client had breached its duty to provide truthful, accurate, and complete representation. This defense could be asserted at the outset of the litigation via a motion to dismiss.]

8. Under what circumstances would a step-down in services immediately cause a CPA to withdraw from the engagement? **(Page 170)**

a. There was a misunderstanding about the nature of the original services. [This answer is incorrect. A misunderstanding of the nature of the various financial services available is an acceptable reason for a step-down in level of service. However, misunderstandings can cause other problems (particularly fee problems), and the CPA should try to avoid them.]

b. The client prohibits the CPA from corresponding with legal counsel about current litigation. [This answer is correct. AR-C 90.90 ordinarily precludes an accountant from agreeing to a step-down from an audit when the accountant has been prohibited from corresponding with the entity's legal counsel for purposes of obtaining evidence on litigation, claims, and assessments. Therefore, in this situation, the CPA would need to withdraw from the engagement.]

c. The requirement for an audit was removed. [This answer is incorrect. Occasionally, the requirement for audited or reviewed or compiled statements is removed after an engagement begins. Agreeing to a step-down in the level of service is generally acceptable in such circumstances.]

d. The scope of an audit is limited by circumstances beyond the client's control. [This answer is incorrect. The implications of a restriction on the scope of an audit or review should be considered carefully, including the possibility that information affected by the scope restriction may be incorrect, incomplete, or otherwise unsatisfactory. If the accountant has such concerns after considering the circumstances of the scope restriction, he should not agree to issue a report based on a lower level of service. However, if the accountant does not have such concerns, then the step-down could be permissible. Therefore, the accountant does not have to withdraw from the engagement immediately, but can consider the circumstances first.]

HOW TO DEAL WITH SUBSEQUENT EVENTS

The period between the balance sheet date and management's issuance of the financial statements is called the *subsequent period*. Subsequent period events or transactions that have a material effect on the financial statements require adjustment or disclosure in the statements. Evidence or information that a subsequent period event or transaction that has a material effect on the financial statements has occurred may come to the accountant's attention—

- During the performance of the compilation or review procedures.
- After the date of the accountant's compilation or review report, but prior to releasing the accountant's report.

In either instance, the accountant should ask management to consider the possible effects the event or transaction might have on the financial statements, including any related disclosure (if disclosures are included). AR-C 90.22f specifically states that as part of the accountant's review procedures, the accountant should inquire of management concerning material subsequent events. Information on such subsequent events should be included in the management representation letter.

FASB ASC 855-10-50-1 requires nonpublic entities whose financial statements include disclosures to disclose the date through which subsequent events have been evaluated and whether that date is the date the financial statements were issued, or the date the financial statements were available to be issued. GAAP requires that a nonpublic entity shall evaluate subsequent events through the date that the financial statements are available to be issued.

FASB ASC 855, *Subsequent Events*, does not change the accountant's responsibilities under the SSARS for subsequent events in compilation and review engagements. The SSARS state that an accountant performing a review engagement should inquire of members of management who have responsibility for financial and accounting matters concerning events subsequent to the date of the financial statements that could have a material effect on the financial statements. In a compilation engagement, the accountant does not have any responsibility with respect to subsequent events unless evidence or information comes to an accountant's attention that a subsequent event that has a material effect on the financial statements has occurred. When such evidence or information comes to an accountant's attention during a compilation or review engagement, the accountant should request that management consider the possible effects on the financial statements, including the adequacy of any related disclosure. If the accountant determines that the subsequent event is not adequately accounted for in the financial statements or adequately disclosed in the notes, the accountant should follow the guidance for GAAP departures. A detailed discussion of this guidance is beyond the scope of this course, but more information is available in *PPC's Guide to Compilation and Review Engagements*.

Occasionally, a subsequent event has such a material impact on the entity that the accountant may wish to include an explanatory paragraph about the event in the accountant's report. Such an explanatory paragraph is not required, but may be added at the accountant's discretion, provided the matter is disclosed in the financial statements.

Types of Subsequent Events

FASB ASC 855-10 includes accounting guidance on subsequent events. There are two types of subsequent events that are often given the short-hand labels of Type I and Type II events:

a. *Type I (recognized subsequent events).* The first type consists of events that provide additional evidence about conditions that existed at the balance sheet date and that affect the estimates inherent in preparing financial statements. The proper accounting treatment of these events is *adjustment* of the financial statements. Subsequent events that affect the realization of assets (e.g., receivables and inventories) or the settlement of estimated liabilities (e.g., product warranty reserves) ordinarily should be adjusted for in the financial statements. Exceptions to this presumption to adjust are changes in the quoted market price of securities because such changes typically are caused by current conditions and events that clearly did not exist at the balance sheet date. Also, settlement of litigation that arose from an event after the balance sheet date or a receivables loss resulting from a customer's major casualty (e.g., fire or flood) after the balance sheet date would not require adjustment.

b. *Type II (nonrecognized subsequent events).* The second type consists of events that did not exist at the balance sheet date but that arose after the balance sheet date but before the financial statements are issued or are available to be issued. Some *nonrecognized subsequent events* may require disclosure to keep the financial statements from being misleading. If disclosure is required, an entity should disclose the nature of the event and an estimate of its financial effect, or a statement that such an estimate cannot be made. Examples of these events include—

   (1) Sale of a bond or capital stock issue.

   (2) Purchase of a business.

   (3) Loss of plant or inventories caused by natural disaster.

Reissued Financial Statements

As noted at FASB ASC 855-10-25-4, when financial statements are reissued, events that require disclosure in the reissued financial statements to keep them from being misleading may have occurred subsequent to the original issuance of the financial statements. Events occurring between the time of original issuance and reissuance of the financial statements should not result in adjustment to the financial statements unless required by GAAP or regulatory requirements.

SUBSEQUENT DISCOVERY OF FACTS THAT EXISTED AT THE DATE OF THE REPORT

Subsequent to the date of the accountant's compilation or review report, the accountant may become aware of facts that existed on that date that might have caused him or her to believe that information supplied by the entity was incorrect, incomplete, or otherwise unsatisfactory had the accountant then been aware of them. AR-C 90.71–77 addresses the accountant's performance requirements for subsequent discovery of facts. The AICPA Guide, Paragraphs 1.202–.208, reiterates those requirements from AR-C 90. Neither the AICPA Guide or AR-C 80 address subsequent discovery of facts in a compilation engagement. However, it seems appropriate to consider following the guidance in AR-C 90 summarized below in compilation engagements, as well.

Legal Implications

Because of the legal implications involved, the accountant would be well advised to consult his or her legal counsel and insurance provider.

Summary of Guidance

The guidance in the SSARS can be summarized as follows:

a. If the information that the accountant becomes aware of is of such a nature and from such a source that the CPA would have investigated it had it come to his attention during the engagement, he should investigate it as soon after it comes to his attention as is practical. In a preparation or compilation engagement, that investigation consists of obtaining additional or revised information. In a review engagement, that investigation consists of performing the additional procedures deemed necessary to achieve limited assurance that there are no material modifications that should be made to the financial statements to be in conformity with generally accepted accounting principles.

b. If, after investigation, the CPA determines that (1) his or her report or the financial statements would have been affected if the information had been known to him or her at the date of the report and (2) he or she believes there are persons currently relying on, or likely to rely on, the financial statements who would attach importance to the information, the CPA should advise his or her client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are relying on the financial statements and the related accountant's report.

c. The method of disclosure by the client might, depending upon the circumstances, take one of the following forms:

   (1) Issuance of revised financial statements and the accountant's report. The reasons for the revision should usually be described in a note to the financial statements referred to in the accountant's report.

   (2) Disclosure of the revision in subsequent financial statements instead of reissuing the earlier statements.

   (3) Notification to the users of the statements that they should not be relied upon and that revised statements will be issued upon completion of an investigation.

d. If the client refuses to make the requested disclosures, the CPA should notify the chair of the board of directors and other appropriate board members, such as the audit committee chair (or owners, if the company has no board of directors), of the client's refusal, and take appropriate steps to prevent future reliance upon the report. In some cases, the accountant may choose to notify all board members.

Even if the decision is made to issue revised financial statements and accountant's report, many practical aspects of that decision remain vague. For example, how should the accountant ensure that all financial statement users have been notified? Should the new report contain a paragraph disclosing the revision? How should the new report be dated? Notification of users is discussed in the following paragraph. An in-depth discussion about reporting on financial statements revised to correct an error is beyond the scope of this course, but more information is available in *PPC's Guide to Compilation and Review Engagements*.

Notification of Users

The literature is vague about what should be done to ensure that the client has informed all financial statement users of a problem with previously issued financial statements. One practical solution is for the client to notify all users of their financial statements that they should no longer be relied upon and that revised statements will be issued. After consultation and agreement with the client, the CPA might directly contact each known user. If the CPA and the client do not agree on a course of action, the CPA should consider consulting legal counsel. After the financial statements have been revised, the accountant might also request a letter from the client indicating that all users have been notified and provided with copies of the revised financial statements and accountant's report. The steps that should be taken will depend upon the accountant's knowledge of persons who are currently using or who will use the financial statements and, if applicable, the accountant's report, and who would attach importance to the information, and the accountant's ability to communicate with them. Unless the accountant's attorney recommends a different course of action, the accountant ordinarily should take the following course of action:

a. Notify the client that the accountant's report must no longer be associated with the financial statements.

b. Notify regulatory agencies having jurisdiction over the client that the accountant's report should no longer be used.

c. Notify each person known to the accountant to be using the financial statements that the financial statements and the accountant's report should no longer be used.

Notification by the accountant to persons other than the client should include a description of the nature of the subsequently acquired information and its effect on the financial statements. The information included in the notification should be as precise and factual as possible and should not go beyond what is reasonably necessary. Comments concerning the conduct or motives of any person should be avoided.

WORKPAPER DOCUMENTATION FOR VARIOUS TYPES OF ENGAGEMENTS

Required Workpapers for a Review Engagement

Workpaper documentation for review engagements is discussed in AR-C 90.91–.92. The accountant should prepare the documentation in sufficient detail to allow an experienced accountant, who is not a member of the engagement team, to understand—

a. The nature, timing, and extent of the procedures performed.

b. The results of the procedures performed and evidence obtained.

c. Significant findings or issues arising during the review, the conclusions reached, and judgments made in reaching those conclusions.

In addition, the review documentation should include the following—

a. Engagement letter.

b. Communications with management regarding fraud or noncompliance with laws and regulations.

c. Communications with management about the accountant's expectation to include an emphasis-of-matter or other-matter paragraph in the accountant's review report.

d. Communications with other accountant that have audited or reviewed the financial statements of significant components.

e. Justification for a departure from a relatively mandatory requirement and how the alternative procedure performed achieved the intent of the requirement, if applicable.

f. Representation letter.

g. Financial statements.

h. Accountant's review report.

It is a best practice for the review workpapers to include only what is required by standards. It is risky from a litigation perspective to do otherwise. For example, accountants often include trial balances of entities that are rolled up into consolidated financial statements in their review workpapers. This is not required and should be avoided. Otherwise, a plaintiff is likely to erroneously assert that the analytical procedures and inquiries should have been applied not only to the reviewed financial statements but to the underlying trial balance details and consolidating information. Some of that detailed information may be problematic and perhaps even suggestive of error or fraud. Not only are accountants not ordinarily required to review such details, but those workpapers do not belong in the review workpaper documentation.

AR-C 90.26 requires the accountant to obtain evidence that the financial statements agree to the accounting records. To obtain such evidence the accountant may compare the financial statements to the accounting records or supporting data in the client's records (AR-C 90.A47). Consequently, most practitioners choose to include a consolidated trial balance that shows agreement to the reviewed financial statements. However, this course does not recommend including the consolidating details.

Required Workpapers for a Compilation Engagement

Workpaper documentation for compilation engagements is discussed in AR-C 80.40. The SSARS say the accountant should prepare documentation in sufficient detail to provide a clear understanding of the work performed. It does not, however, specify the form and content of the documentation but states that, at a minimum, the following should be included:

a. Engagement letter.

b. Justification for a departure from a relatively mandatory requirement and how the alternative procedure performed achieved the intent of the requirement, if applicable.

c. Financial statements.

d. Accountant's compilation report.

It is a best practice for the compilation workpapers to only include what is required by standards. That is, accountants should: (a) avoid extraneous clutter in the compilation workpapers, (b) adhere to the minimum compilation documentation requirements above, and (c) only go beyond those requirements when needed to provide a clear understanding of the work performed. To do otherwise may subject accountants to increased malpractice risks.

Required Workpapers for a Financial Statement Preparation Engagement

AR-C 70.22 requires the accountant to prepare documentation in sufficient detail to provide a clear understanding of the work performed in connection with each preparation engagement. At a minimum, that documentation should include:

a. Engagement letter.

b. Financial statements.

Documentation Requirements for Nonattest Services

ET 1.295 of the Code requires accountants who perform nonattest services for their compilation or review clients to document in writing their understanding concerning those nonattest services with their client. The Code does not specify how the written understanding is to be documented, so the accountant has flexibility. For example, the understanding might be documented in a separate engagement letter, in the workpapers, in an internal memo, or in the engagement letter obtained in conjunction with the compilation or review. Checklists could also be used, such as those included in *PPC's Guide to Compilation and Review Engagements*.

Use of Checklists and Forms

Many CPAs will find that standard checklists and forms designed for their practices are useful in documenting compliance with the requirements of the SSARS and the quality control standards. Such checklists, of course, cannot be used blindly and are not substitutes for professional judgment.

Use of the Term *Partner*. This course often uses the term *partner* (for example, partner, engagement partner, or concurring partner) to indicate an individual holding a position of ownership. However, with the varied forms of legal entities in which CPA firms are permitted to practice, the term *partner* may not describe the position of ownership in some firms. For firms structured in legal forms other than partnerships (such as professional corporations and limited liability partnerships), this term should be viewed as interchangeable with *owner*, *shareholder*, *principal*, *director*, or *member*. Use of the term *partner* is not intended to imply that the firm is operating as a partnership.

Maintaining Engagement Documentation

Assembly of Engagement Documentation. QC 10.49 specifies that firms establish policies and procedures that require engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been released." Those policies and procedures should comply with any time limits established by professional standards, laws, or regulations that address the assembly of final engagement files for specific types of engagements.

Time limits for completing the assembly of final engagement files may be prescribed by professional standards, laws, or regulations. When no such time limits are prescribed, the firm is required to establish time limits that reflect the need to complete the assembly of final engagement files on a timely basis. Firms may adopt documentation completion periods either on an engagement-by-engagement basis, or as part of the firm's quality control policies and procedures.

Timely completion of engagement documentation is important to ensure engagement quality. As a practical matter, firms should strive to prepare engagement documentation as the engagement progresses to avoid inadvertently omitting critical information or incorrectly recording aspects of the procedures that were completed or the evidence obtained. Additionally, striving to assemble and maintain engagement documentation as the engagement progresses serves to make assembly of the engagement documentation more efficient.

Compilation and Review Documentation Assembly Requirements. The SSARS (AR-C 60.21diii) specify that the engagement partner should take responsibility for ensuring that appropriate engagement documentation is maintained for all engagements performed under the SSARS. This requirement is included in a list of requirements directing the engagement partner to ensure that SSARS engagements are performed in accordance with the firm's quality control policies and procedures. Thus, the requirement is not specific or limited to only assembly of engagement documentation; it is broader, encompassing engagement documentation in totality.

Retention of Engagement Documentation. QC 10.51 states that firms should establish policies and procedures for the retention of engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations. QC 10.A61 adopts procedures that enable the preceding requirement to be met during the retention period and includes procedures, for example, that—

- Enable the retrieval of and access to engagement documentation during the retention period (particularly in the case of electronic documentation), as the underlying technology may need to be upgraded or revised over time.
- Where necessary, provide a record of changes made to engagement documentation after the assembly process is complete.
- Allow suitably qualified external individuals (those providing EQCR or consultation services, for example) and peer reviewers to easily access and review necessary engagement documentation.

Firms should also be aware that various states have enacted legislation or regulations that may require a stipulated retention period. In some cases, government agencies have specific record retention requirements that are made part of the contract for the specified engagement performance. Additionally, there may exist generally accepted retention periods in the absence of specific legal or regulatory requirements. Firms might consider consulting their attorneys and insurance carriers when establishing their retention policies.

Document retention policies should also recognize the need for exceptions in extenuating circumstances. Most notable, when engagement documentation is the subject of a subpoena, or contemplated or threatened subpoena or summons, no file or document destruction should occur until the related issues have been fully settled.

Compilation and Review Documentation Retention Requirements. SSARS does not address or establish requirements for the retention of workpapers. As is the case with document assembly, the engagement documentation retention requirements of QC 10apply to accountants performing SSARS engagements. Not only should a firm develop procedures over the retention of compilation and review documentation, a firm should also include such policies and procedures in their QC system.

Retention Location. Accountants who perform compilation or review services for a client often perform other nonattest services, such as tax return preparation or bookkeeping services, or other attest services for the same client. In these instances, the question often arises regarding where the accountant who performs these multiple services for a client should file the workpapers. In other words, should all of the workpapers related to a client be filed together, should separate complete files be maintained for each type of service, or can the files for each type of service share some documents? Additionally, if a portion of the workpapers are electronic with the remaining portion being manual, how should the workpapers be filed?

This course suggests that neither the format or the location are relevant. It is only important that the accountant retain all of the required documentation and be able to locate this documentation when it is necessary (i.e., peer review, court order, use in subsequent years, etc.). Best practices would suggest that although accountants may maintain separate files for the engagements performed for an individual client, the accountant should store all of the engagement work related to an individual client together. In addition, best practices would also suggest that each manual workpaper related to a predominately electronic engagement should be listed in the electronic workpaper index as an external workpaper.

A best practice would be to follow a written record retention policy that includes an annual purge of files (whether electronic or paper). The policy should provide guidance applicable to the firm's practice considering laws, regulations, and state board rules. Issues such as carry forward basis issues for tax, estate return issues, gift tax issues, and other client service issues should also be addressed in a firm's policy. Care should also be taken to return client original records such as journal entries, depreciation schedules, basis calculations, etc., annually upon completion of each engagement so the client has a complete set of its accounting records to carry forward.

Confidentiality, Custody, Integrity, Accessibility, and Retrievability of Engagement Documentation. QC 10.50 indicates that firms "should establish policies and procedures that are designed to provide for the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.

Confidentiality. The need to provide for a confidential relationship with a client is expressed in the *Confidential Client Information Rule of* the Code (ET 1.700.001.01) which states members in public practice should not disclose any confidential client information without obtaining the client's specific consent. Ordinarily, engagement documentation can be shown outside of the firm only with the client's explicit permission. This is true even if a practitioner sells his or her practice to another firm, and it also applies to a predecessor communicating with a successor accountant. Specific laws or regulations may impose additional obligations on the firm to maintain client confidentiality, particularly when data of a personal nature are concerned.

There are some limited exceptions to engagement documentation confidentiality. For example, explicit permission is not required for making engagement workpapers available if subpoenaed in connection with a court proceeding, if requested in an ethical disciplinary proceeding, or if submitted in an AICPA or state CPA society authorized quality or peer review program. Also, *Disclosing Client Information During Litigation* (ET 1.700.070.01) clarifies the firm's responsibility when providing confidential client information to the firm's professional liability insurance carrier; the firm is not required to obtain a client's permission if the information is provided solely to assist in the defense against an actual or potential claim against the firm.

Custody, Integrity, Accessibility, and Retrievability. Engagement documentation may exist on paper, electronically, or in some other media. Regardless of how it exists, the integrity, accessibility, and retrievability of the underlying data may be compromised if the documentation could be altered, added to, or deleted without the firm's knowledge. Accordingly, controls are necessary to prevent engagement documentation from unauthorized use or alteration, or from becoming lost or damaged. The application and other explanatory material of QC 10.A56 indicates that, to avoid unauthorized alteration or loss, controls over engagement documentation may include controls that enable the firm to—

- Determine when and by whom engagement documentation was prepared and reviewed.
- Protect the integrity of information at all stages of the engagement, especially when information is shared within the engagement team or transmitted to other parties via electronic means.
- Prevent unauthorized changes to engagement documentation.
- Allow access to engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

Electronic Engagement Documentation. Many firms use paperless engagement software. As a result, the firm may scan engagement documents or otherwise convert original paper documentation to another media for inclusion in the engagement files. When that is the case, QC 10.A58 indicates that the firm's procedures may include requiring engagement team members to:

- Generate scanned copies that reflect a complete copy of the document (such as both sides of two-sided documents) and capture manual signatures, cross-references, and annotations.

- Integrate the scanned copies into the electronic engagement files, including indexing and signing off on the scanned copies as necessary.

- Enable the scanned copies to be retrieved and printed as needed.

Even firms that have completely achieved the *paperless office* concept for their engagements may have legal, regulatory, or other reasons to retain some original paper documentation. Accordingly, those firms should ensure that their QC policies and procedures over engagement documentation confidentiality, safe custody, integrity, accessibility, and retrievability encompass hard copy documents as well.

Additional controls that firms might design and implement to maintain the safe custody, integrity, accessibility, and retrievability of engagement documentation may include controls such as the following:

- The use of data encryption and passwords by engagement team members to restrict access to electronic engagement documentation to authorized users.

- Back-up routines for electronic engagement documentation at appropriate stages during the engagement.

- Procedures for distributing engagement documentation to the team members at the beginning of the engagement, processing it during the engagement, and collating it at the end of the engagement.

- Procedures to restrict access to, and enable proper distribution and confidential storage of, hard copy engagement documentation.

Another item for consideration should be email and other forms of electronic communications among the team members and client personnel. This is a significant litigation risk in a compilation and review practice. Those communications have to be produced in discovery during legal proceedings. Furthermore, they cannot be destroyed in anticipation of litigation. They nearly always hurt the CPA firm's defense and rarely help it. Why? Because the communications frequently raise questions about incomplete information, or even questionable information, without any documentation of how those matters were resolved in additional emails or in the workpapers. It is a best practice to limit electronic communications and destroying any of those communications that are not part of the engagement documentation when the engagement is archived. In addition, it is a good idea to have periodic training for professional staff on email protocol and the risks related to "thinking with other engagement team members through email."

SELF-STUDY QUIZ

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

9. Which of the following is an example of a Type I subsequent event for which the financial statements need to be adjusted?

   a. SmallCo owns securities that undergo a significant change in market price.

   b. LargeCo purchases a new business.

   c. BringCo loses one of its facilities in a natural disaster.

   d. MediCo has a problem with a large shipment of inventory that will cause a recall.

10. If an accountant subsequently discovers facts that existed at the date of the report that might have caused him to believe information supplied by the client was incorrect, incomplete, or unsatisfactory, what is the first thing the accountant should do?

    a. Withdraw from the engagement.

    b. Investigate the new information.

    c. Notify users that the report is not reliable.

    d. Issue a revised report.

11. The workpapers for what type of engagement include communications with management concerning fraud and noncompliance, as well as including an emphasis-of-matter or other-matter paragraph in the report; communications with other accountants who either audited or reviewed the financial statements of any significant components; and a representation letter?

    a. A review.

    b. A compilation.

    c. A financial statement preparation engagement.

    d. An engagement to perform nonattest services.

SELF-STUDY ANSWERS

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

9. Which of the following is an example of a Type I subsequent event for which the financial statements need to be adjusted? **(Page 176)**

   a. SmallCo owns securities that undergo a significant change in market price. [This answer is incorrect. This is an exception to the rule about adjusting the financial statements for Type I subsequent events. Change in the quoted market price of securities is caused by current conditions and events that clearly did not exist at the balance sheet date.]

   b. LargeCo purchases a new business. [This answer is incorrect. This would be considered a Type II subsequent event, not a Type I subsequent event. Therefore, even though this event would need to be disclosed, there is a better answer to this question.]

   c. BringCo loses one of its facilities in a natural disaster. [This answer is incorrect. This is a Type II subsequent event. It still should be disclosed; however, it does not fulfill the requirements for this question as it is not a Type I subsequent event.]

   d. MediCo has a problem with a large shipment of inventory that will cause a recall. [This answer is correct. Type I subsequent events provide evidence about conditions that existed at the balance sheet date and that affect the estimates inherent in preparing financial statements. The proper accounting treatment of these events is *adjustment* of the financial statements. Subsequent events that affect the realization of assets (e.g., receivables and inventories) or the settlement of estimated liabilities (e.g., product warranty reserves) ordinarily should be adjusted for in the financial statements. Therefore, MediCo's financial statements will need to be adjusted for this Type I subsequent event.]

10. If an accountant subsequently discovers facts that existed at the date of the report that might have caused him to believe information supplied by the client was incorrect, incomplete, or unsatisfactory, what is the first thing the accountant should do? **(Page 177)**

    a. Withdraw from the engagement. [This answer is incorrect. At this point, the engagement is complete, so the accountant can no longer withdraw. Other actions must be taken.]

    b. Investigate the new information. [This answer is correct. If the information that the accountant becomes aware of is of such a nature and from such a source that the CPA would have investigated it had it come to his attention during the engagement, he should investigate it as soon after it comes to his attention as is practical. Once the investigation is complete, the CPA will need to make other determinations regarding his report.]

    c. Notify users that the report is not reliable. [This answer is incorrect. While the accountant may need to take this action under such circumstances, it would not be the first resort. The accountant should take other actions first.]

    d. Issue a revised report. [This answer is incorrect. The accountant may end up issuing a revised report; however, other actions must be taken before this option is chosen.]

11. The workpapers for what type of engagement include communications with management concerning fraud and noncompliance, as well as including an emphasis-of-matter or other-matter paragraph in the report; communications with other accountants who either audited or reviewed the financial statements of any significant components; and a representation letter? **(Page 179)**

    a. A review. [This answer is correct. Workpaper documentation for review engagements is discussed in AR-C 90.91–.92. The documentation must be prepared in sufficient detail to allow an experienced accountant who was not on the engagement team to understand certain specific items. In addition, the workpapers should include (1) an engagement letter, (2) communications with management regarding fraud or noncompliance with laws and regulations, (3) communications with management about the accountant's expectation to include an emphasis-of-matter or other-matter paragraph in the accountant's review report, (4) communications with other accountants that have audited or reviewed the financial statements of significant components, (5) justification for a departure from a relatively mandatory requirement and how the alternative procedure performed achieved the intent of the requirement, if applicable, (6) a representation letter, (7) the financial statements, and (8) the accountant's review report.]

    b. A compilation. [This answer is incorrect. AR-C 80.38 does not specify the form and content of documentation for a compilation engagement; however, it says that, at a minimum, an engagement letter, financial statements, and the accountant's compilation report should be included.]

    c. A financial statement preparation engagement. [This answer is incorrect. At a minimum, according to AR-C 70.21, the workpapers for a financial statement preparation engagement should include an engagement letter and financial statements. All of the items listed above are not required for this type of engagement.]

    d. An engagement to perform nonattest services. [This answer is incorrect. ET 1.295 of the AICPA *Code of Professional Conduct* requires accountants who perform nonattest services for their compilation or review clients to document in writing their understanding concerning those nonattest services with their client. The Code does not specify how the written understanding is to be documented, so the accountant has flexibility. Therefore, the items listed above would not be required to be included.]

Lesson 2: Issues Related to the Administration of Compilation and Review Engagements, Part II

INTRODUCTION

Lesson 2 continues the discussion of engagement administration related to compilation and review engagements. This lesson begins with a discussion of communications that are required between predecessor and successor accountants.

Next, this lesson discusses common practice issues that occur in compilation and review engagements. Topics covered include litigation risks, the accountant's responsibility for fraud and noncompliance with fraud and regulations, bookkeeping services, and other issues.

Lesson 2 continues with a discussion of requirements related to quality control, peer review, and ethics standards that affect compilation and review firms. Then the lesson takes a look at other administrative forms and accounting software.

Finally, this lesson concludes by examining independence issues that may affect compilation and review engagements and how to deal with consultation and differences of opinion in these types of engagements.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine what communications are needed between predecessor and successor accountants and how to deal with common practice issues in compilation and review engagements.
- Identify the requirements for quality control, peer review, and ethics standards when a firm performs compilation and review engagements.
- Identify the ways accounting software can be used and how to deal with independence issues, consultation, and differences of opinion.

COMMUNICATIONS BETWEEN SUCCESSOR AND PREDECESSOR ACCOUNTANTS

A successor accountant is *not* required to communicate with a predecessor in connection with a compilation or review engagement. (Note: AU-C 510 requires communication between successor and predecessor *auditors*. However, a successor accountant *may* decide to communicate with the predecessor. The AICPA Guide addresses communications when prior-period financial statements require revision.The SSARS do not include guidance concerning communications between predecessor and successor accountants. However, if the successor wishes to make inquiries of the predecessor and the client refuses, the accountant should consider the reasons for the refusal and its implications on accepting the engagement. The refusal itself does not preclude an accountant from accepting the engagement; however, the refusal may cause doubt about management's integrity or management's reliability in making available all relevant resources and information. According to AR-C 60.25, those doubts, in addition to doubt about relevant ethical requirements (such as independence requirements) being able to be satisfied, provide a reasonable basis for not accepting a SSARS engagement.

Communications in Connection with Acceptance of an Engagement

Communication between predecessor and successor accountants in connection with the acceptance of an engagement may be desirable when—

a. Information about the prospective client is limited or requires special attention.

b. The change in accountants occurs substantially after the end of the accounting period for which financial statements are to be compiled or reviewed.

c. The client has frequently changed accountants.

If the successor elects to communicate, orally or in writing, with the predecessor, inquiries such as the following might be made:

a. Does the client have integrity?

b. Has the predecessor had disagreements with the client about accounting matters or the performance of compilation or review procedures?

c. Has the client cooperated when additional or revised information was needed?

d. Does the predecessor have any knowledge of any fraud or noncompliance with laws and regulations perpetrated within the client?

e. Why has the client switched accountants?

The predecessor should respond fully to the successor's request for information. If, however, due to unusual circumstances (which include such things as impending, threatened, or potential litigation or disciplinary proceedings, but do not include unpaid fees), the predecessor decides not to respond fully, he should indicate that his response is limited. If this happens, the successor should consider whether he can accept the engagement.

The successor may wish to obtain access to the predecessor's workpapers. Ordinarily, workpapers relating to matters of continuing accounting significance and those relating to contingencies should be made available by the predecessor. However, valid business reasons (e.g., unpaid fees) may lead the predecessor to decide not to allow access to his workpapers. (Caveat: Ethics rulings prohibit a predecessor accountant from withholding books and records belonging to the client regardless of any unpaid fees.) If the successor uses the predecessor's workpapers, no reference to the predecessor accountant should be made in the compilation or review report except as specifically permitted with respect to comparative financial statements.

As required by the Code, a successor accountant should obtain the client's permission if he decides to make inquiries of the predecessor, and the client should authorize the predecessor to respond fully. If the client will not permit communication, the successor should consider withdrawing from or not accepting the engagement. The successor accountant may make inquiries before making a proposal for the engagement. In addition, before permitting access to the working papers, the predecessor accountant may wish to obtain a written communication from the successor accountant regarding the use of the working papers.

Communications When Successor Believes Prior-period Financial Statements Require Revision

When, during the course of his compilation or review engagement, the successor accountant becomes aware of information that leads him to believe the prior-period financial statements reported on by the predecessor accountant require revision, a successor accountant may request that the client communicate that information to the predecessor accountant. (Lesson 1 provided additional guidance on determining an appropriate course of action for subsequently discovered facts.) If the client refuses or if the successor is not satisfied with the course of action taken by the predecessor, it is a best practice for the successor accountant to evaluate the possible implications for the current engagement and consider whether to resign from the engagement. In addition, the successor accountant may wish to consult with his attorney.

An in-depth discussion of what to do if the successor becomes aware of information that leads him to believe that the financial statements reported on by the predecessor need to be revised is beyond the scope of this course, but more information is available in *PPC's Guide to Compilation and Review Engagements*.

PRACTICE ISSUES THAT MAY OCCUR DURING COMPILATION AND REVIEW ENGAGEMENTS

Practicing a profession is generally a stimulating and intellectually rewarding undertaking; however, practice issues and the threat of legal liability can cast shadows on professional lives and ruin an otherwise successful professional career. This section addresses several practice issues that accountants should consider while performing compilation and review engagements.

Litigation Risks

Although there is a lack of published cases on compilation and review engagements, liability insurance claims against CPA firms strike at a rate of one claim per year for approximately every 120 professionals. Claims arising from compilation engagements alone compose 6% of all malpractice claims filed each year. CPA firms that do only tax, compilation, and review work should never assume that their malpractice risk is immaterial, as it is not unusual for small CPA firms with no audit practice to be hit with claims seeking in excess of $1 million. Because of the potentially disastrous effects of liability claims, every CPA firm needs to develop systems designed to avoid liability claims and to minimize their impact. Defensive measures CPA firms should use include—

- Quality control (which covers compilation and review engagements),
- Professional liability insurance,
- Other protective measures, and
- Engagement letters (which are required in all compilation and review engagements).

Quality Control. QC 10, establishes standards and provides guidance for a CPA firm's system of quality control responsibilities for its accounting and auditing practice. QC 10 requires the firm to establish a system of quality control designed to provide reasonable assurance that the firm complies with professional standards and issues reports appropriate in the circumstances. The standard also requires the firm to document and communicate its quality control policies and procedures. QC 10 is discussed in more detail later in this lesson.

Traditionally, CPA firms have tried to employ quality control systems as their first line of defense on the assumption that a firm that practices according to the dictates of the profession makes itself invulnerable to liability claims. While following quality control measures clearly decreases the possibility of substandard performance, it is by no means a perfect defense against claims. In order to maximize compliance with applicable professional standards and minimize risks of substandard performance, however, every CPA firm should develop a quality control system as discussed in the following section.

In accountants' liability cases, professional standards are not the "end all" for CPAs. Many CPAs believe they are protected from liability lawsuits because they followed the rules. They also think that conformity with professional standards provides a safe harbor against liability. Unfortunately, that is often not the case when defending a liability claim. Professional standards are vitally important, but complying with professional standards may not be sufficient to avoid liability. CPAs are expected not only to follow standards, but to get it right. While other defenses are available to CPAs, the failure to follow a CPA's internal quality control standards becomes a significant obstacle to overcome in avoiding legal liability. Therefore, it is essential that the CPA firm design a quality control system that simultaneously satisfies professional standards and is practical and appropriate for the size and type of firm.

Professional Liability Insurance. CPA firms rely on professional liability insurance to pay the liabilities and costs of defending against claims. While liability insurance is essential for all professional firms, it is only one resource for protection of a professional's assets and not a means to prevent liability. At the same time, all professional liability insurers impose their own standards of quality control and implementation of quality control measures on their insured professionals.

Notwithstanding the relatively competitive state of the malpractice insurance market, it is not clear that every insurer will provide coverage for all claims that may arise out of the wide variety of services that are now being offered by CPA firms. This is especially true of claims based on erroneous investment advice, as many insurers remain unwilling to cover such claims. Insurance generally does not protect against liability awards based on fraud by the CPA. Before undertaking new services, a professional firm should explore with its insurer whether such services are included within the definition of covered professional services.

Equally important, it is virtually impossible for accounting firms to purchase enough insurance to cover the largest claims that may be asserted against them. Even if such insurance were available, it would likely be too costly for an accounting firm to purchase on an annual basis. Thus, even those firms that do purchase professional liability insurance are likely to face the possibility that such insurance may not cover the full extent of the claims that may be asserted against them.

Other Protective Measures

Because of the limitations in professional liability insurance and the inability of some CPA firms to purchase insurance with sufficient policy limits to cover their full risk exposure, a CPA firm must turn to the following protective measures to minimize the impact of any claims or potential claims against the firm:

- Risk avoidance.
- Firm structure.
- Damage control.

Risk Avoidance. Risk avoidance includes a variety of loss prevention techniques that focus on limiting the types of clients and engagements the firm accepts. Gone are the days when CPA firms made client acceptance decisions solely on the basis of whether the engagement could be performed profitably. Today, before accepting an engagement, CPA firms must not only examine the economics of servicing the client but also the potential liability risks posed by the engagement. (QC 10 requires firms to establish policies and procedures for client and engagement acceptance and continuance.)

Firm Structure. Another protective measure is to insulate the assets of the firm and its owners in the event that the firm's defenses against liability prove ineffective and either liability insurance is not available for such claims or the policy limits are exceeded. Subject to state laws and regulations affecting professional organizations, a firm should be organized as a legal entity (professional corporation, limited liability partnership, or limited liability company) which, to a degree, insulates its owners from the liabilities of the firm. It should be noted that most state statutes will continue to hold the owner who breaches professional obligations responsible for his or her own actions and the actions of the persons he or she supervises. If any claim against the firm is successful, the liability is satisfied first out of a firm's professional liability insurance and then out of the firm's assets. Notwithstanding the foregoing, the firm and its owners will continue to be responsible for the retention amounts associated with the firm's liability policy.

In addition to these structural protections, CPAs can protect their personal assets in a number of other ways, including placing assets in protected pension plans and holding property jointly with others with rights to survivorship. Moreover, personal assets may be protected by personal liability insurance, outright transfers of assets to others, or assets placed in a trust.

Damage Control. Another protective measure is the establishment of an internal procedure for managing any claims threatened or actually asserted against the professional. Damage control procedures focus on responding quickly to threatened and actual liability claims. Often the manner in which a firm handles internal communications and communications with counsel when a claim is first threatened or asserted may have an impact on the ultimate resolution of such a claim.

Engagement Letters. Finally, as discussed in Lesson 1, the SSARS require practitioners to always utilize an engagement letter when performing preparation, compilation, and review engagements. The form and content of the letters should be structured to help minimize legal liability.

Responsibility for Fraud and Noncompliance with Laws and Regulations

The SSARS set forth the accountant's responsibilities for fraud and noncompliance with laws and regulations in compilation and review engagements. The SSARS defines *fraud* as an intentional act that causes a misstatement in the financial statements and defines *noncompliance* as intentional or unintentional violations of laws or government regulations, excluding fraud.

Do AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, and AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, apply to compilation and review engagements? The answer is no. AU-C 240 and AU-C 250 apply only to audits of financial statements conducted in accordance with generally accepted auditing standards. SSARS performance standards do not require accountants to document their assessment of fraud in a compilation or review engagement. Nor do SSARS performance requirements impose detection requirements for noncompliance with laws and regulations. However, in a review engagement, the accountant is required to obtain limited assurance about whether the financial statements are free of material misstatement, whether caused by error, fraud, or noncompliance with laws and regulations. AR-C 90 states that when conducting a review of financial statements, the accountant should inquire of members of management who have financial and accounting responsibilities concerning their knowledge of any fraud or suspected fraud that could have a material impact on the financial statements. The inquiry and analytical procedures performed in a review should provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the financial statements. No expression of assurance is contemplated in a compilation. In addition, the SSARS obligate the accountant in both compilation (AR-C 80.14) and review (AR-C 90.29) engagements to obtain additional or revised information when the accountant becomes aware of information that is incorrect, incomplete, or otherwise unsatisfactory.

Use of Engagement Letters to Clarify the Accountant's Responsibilities. Management is responsible for the prevention and detection of fraud and noncompliance with laws and regulations, and the maintenance of internal control. However, many small business clients do not understand management's responsibility. They may have unrealistic expectations and may assume that the accountant is providing a higher level of assurance than he or she actually is, including detecting fraud, noncompliance with laws and regulations, and internal control deficiencies. A written engagement letter is required by AR-C 70.10, AR-C 80.10, and AR-C 90.11 and can be helpful in clarifying and documenting the understanding of the accountant's responsibility regarding fraud, noncompliance with laws and regulations, and internal control deficiencies. This written understanding should provide, among other things, that the engagement cannot be relied upon to disclose errors, fraud, or noncompliance with laws and regulations. Engagement letters were discussed in more detail in Lesson 1.

Whether an act actually is fraudulent or a violation of laws and regulations is a determination that is normally beyond the accountant's professional competence. Accountants—when reporting on financial statements—present themselves as being proficient in accounting and compilation and review services. The accountant's training, experience, and understanding of the client and its industry may cause him or her to recognize some client acts as fraudulent or a violation of laws and regulations. However, the determination of whether a particular act is fraudulent or a violation of laws and regulations should be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law.

Client Representation Letters in Review Engagements. In addition, AR-C 90.34 requires the accountant to obtain written representations, including the following fraud-related representations, for all financial statements and periods covered by the accountant's review report:

- Management's acknowledgment of its responsibility to prevent and detect fraud.
- Knowledge of any fraud or suspected fraud that could have a material effect on the financial statements, such as communications about fraud received from employees, former employees, or others.

These representations help clarify and document management's understanding of its responsibilities regarding fraud.

Communication of Suspected Fraud or Noncompliance with Laws and Regulations. AR-C 90.51 addresses the question of what the accountant should do to communicate suspected fraud or noncompliance with laws and regulations discovered during the performance of a review engagement. When the accountant suspects fraud or noncompliance with laws and regulations may have occurred, the matter should be communicated to the appropriate level of management. The accountant is required to report all suspected fraud; however, the accountant need not report matters regarding noncompliance with laws and regulations that are clearly inconsequential (e.g., misdemeanor traffic violation) and may reach agreement in advance with the entity on the nature of any such matters to be communicated. It is a best practice to report *all* suspected fraud and noncompliance with laws and regulations. If the suspected fraud or noncompliance with laws and regulations involve senior management, then the matter should be communicated at the highest level within the company. And, if the suspected fraud or noncompliance with laws and regulations involves the owner of the company, the accountant should consider resigning from the engagement and consulting legal counsel. Additional procedures are not required to substantiate whether fraud or noncompliance with laws and regulations have, in fact, occurred. However, the accountant should request that management consider the effect of the matter on the financial statements. In addition, the accountant should consider the impact the suspected matters might have on the engagement. The accountant is required to document any communications, whether oral or written, regarding fraud or noncompliance with laws and regulations. AR-C 80 does not address communications about fraud and noncompliance with laws and regulations and, therefore, does not have a requirement to communicate or document any communication. However, it is a best practice to do so.

The disclosure of any evidence or information that comes to the accountant's attention during the performance of the compilation or review procedures that indicate fraud or noncompliance with laws and regulations may have occurred to third parties is not usually the accountant's responsibility. In fact, in most instances, the accountant is precluded from communicating such matters to third parties by ethical and legal obligations of confidentiality. There are certain instances, however, such as complying with legal and regulatory requirements, communicating with a successor accountant regarding acceptance of an engagement, and responding to a subpoena, where an accountant has a duty to disclose matters related to fraud and noncompliance with laws and regulations to parties outside of the entity.

Other Practice Issues

Bookkeeping Services. Accountants who perform SSARS engagements for their clients often also perform bookkeeping services for those same clients. Bookkeeping engagements have usually been viewed as presenting minimal professional liability risk because the accountant provides no assurance and the work is relatively straight-forward and without technical complexities. However, if a client company suffers a financial loss due to fraud or theft, the accountant is often viewed by the client as contributing to the loss. Consequently, there is a growing trend of lawsuits being filed against accountants who perform bookkeeping services when the accountant fails to detect fraud or theft.

The potential for fraud exists on all engagements. The accountant's responsibility to detect fraud is often different than the public's perception of the accountant's responsibility. See the discussion of the accountant's responsibility for fraud in SSARS engagements earlier in this lesson. When performing bookkeeping services, it is a best practice for the accountant to take special care in having an engagement letter that specifically details exactly what procedures the accountant will perform. This is especially important as it relates to any work being performed relative to the cash account. For example, if the accountant is performing a bank reconciliation, the engagement letter should specify exactly what procedures will (or will not) be performed with respect to the payee and endorsement of the cancelled checks. That is, the engagement letter should clearly communicate whether the accountant will look at cancelled checks to review for proper payees or endorsements.

Licensing Problems. State legislatures and the courts have determined that it is in the public interest to regulate professional services offered by CPAs. Accountancy laws governing the licensing of certified public accountants and prescribing entry requirements for those who wish to hold themselves out to the public to practice accounting have been enacted in all fifty states, District of Columbia, Puerto Rico, Guam, and Virgin Islands.

CPAs should also consider applicable state board of accountancy licensing and registration requirements for the firm and its personnel. Most states require firms to possess a firm (also known as a practice unit) license. Accordingly, sole practitioners are ordinarily required to possess two licenses: a firm license and an individual license to practice as a CPA. In all other firms, in addition to the one firm license, each professional in the firm who has passed the Uniform CPA Exam and has met the experience requirement of their state board is also required (in most states) to possess an individual CPA license. During a peer review, a firm will be asked to provide written representation that the firm is in compliance with all licensing requirements and that firm members are in compliance with individual licensing requirements. In addition, a reviewer is required to verify the firm's practice unit license in the state the firm is domiciled and, for a sample of personnel, individual licenses in the state in which the individual primarily practices public accounting. Verification is met by the firm providing documentation from the licensing authority that the license is appropriate and active during the peer review year, and through the earlier of the reviewed engagements' issuance dates or the date of peer review fieldwork. A firm may also do business in states other than where it is domiciled. Those states may also require licenses. In addition, if a CPA is acting as an expert witness in a state in which he or she is not licensed, his or her testimony may be disallowed. Many other issues also arise due to improper licensing. Although many state requirements are similar to those of the AICPA, they do vary from state to state. Because the licensing rules may vary from state to state, the CPA firm should investigate a state's licensing requirements by contacting the applicable state board or consulting an attorney prior to doing business in that state.

Commissions, Referral Fees, and Contingent Fees. ET 1.520.001.01 of the Code prohibits members from accepting commissions and referral fees from clients for whom the member performs the following:

a. Examinations of prospective financial information.

b. Audits of financial statements.

c. Reviews of financial statements.

d. Compilations of financial statements, unless the report discloses a lack of independence.

ET 1.510.001.01 of the Code prohibits a member from accepting contingent fees from a client for whom he performs any of the services described in the previous paragraph. In addition, it prohibits a member from accepting contingent fees for preparing an original or amended tax return or a claim for refund. There are certain exceptions to the prohibition of contingent fees as noted in ET 1.510.001.03.

When deciding whether to accept commissions, referral fees, and contingent fees, practitioners also should consider the rules and regulations of the states in which they practice. Many states have specific laws governing the acceptance of commissions, referral fees, and contingent fees, some of which may differ from the AICPA's rules.

Liability to Third Parties. The law has long limited who can assert claims against a CPA firm based upon the CPA firm's professional negligence. This process began in 1931 with the decision of the New York State Court of Appeals in *Ultramares v. Touche* in which the court held that a CPA firm could only be sued on a negligence theory by those persons with whom the CPA firm had entered into a contractual or privity relationship (i.e., the CPA firm's client). This doctrine, generally referred to as the privity doctrine, went on to be adopted by all courts that encountered the issue over the course of the next 30 years. Beginning in the 1960s, however, courts in some states began to view this doctrine as being artificial, outdated, and overly restrictive, as other business enterprises did not enjoy a similar restriction on their liability exposures. Over the course of the next 30 years, the courts in most states wrestled with this question, and today there are three distinct ways in which the courts of the various states deal with the privity issue.

<u>States That Follow the Privity Doctrine.</u> Sixteen states follow the privity rule as originally described in *Ultramares v. Touche* or a more modern version of that doctrine described by the New York Court of Appeals in its 1985 decision in *Credit Alliance v. Arthur Andersen*. (Those states are listed in Exhibit 5-1.) In that case, the court held that persons who may sue an accounting firm on a negligence standard include not only the CPA firm's clients but also those persons the firm knew would be relying upon the firm's report and with whom the firm maintained a relationship similar to that of an accountant-client relationship. This would include banks and other creditors of the CPA firm's client with whom the accounting firm had direct dealings relating to the extension of credit to the client. Under the New York court's interpretation, the mere fact that the third-party creditor may have called the accounting firm or written it a letter informing the accounting firm of its intention to rely upon the firm's report would not create the necessary near privity relationship.

Each of the 16 states that currently embraces the privity doctrine has done so in its own way. Approximately one-half of these states have adopted it through court decisions, some of which use the language of the New York Court of Appeals in *Credit Alliance v. Arthur Andersen* that requires *linking conduct* on the part of the defendant accounting firm evidencing its knowledge that the plaintiff will rely upon its report. Other states adopting the privity doctrine through judicial decisions have done so without reference to *linking conduct*. The remaining states have adopted the privity doctrine through legislation (often reversing court decisions that rejected the privity doctrine). That legislation was achieved in part through the concerted effort of the accounting profession to adopt a standard limiting the accountant's duty of due care to the accountant's client and those persons whom the accountant has acknowledged in writing will be relying on his or her report. Even so, the resulting legislation is not uniform by state. For example, in New Jersey, banks and other financial institutions can achieve "privity" status only by obtaining a written acknowledgment from the CPA firm, whereas others can simply prove that there was communication between the plaintiff and the firm regarding the plaintiff's intended reliance. In Illinois, a written statement by the accountant to the client acknowledging the plaintiff's intended reliance provides "privity" status to the plaintiff. The statutes adopting the privity rule frequently refer to accountants or firms licensed or registered to practice accounting within the state. Accordingly, some courts have taken the position that those statutes do not apply to accountants and/or firms that are not so licensed or registered. This is an important reason to make sure that all licensing requirements have been complied with prior to rendering services to a client in another state.

States That Follow the Restatement Standard. Twenty-three states (as listed in Exhibit 2-1) have adopted the restatement standard, which is the test recommended in the *Restatement (Second) of the Law of Torts* published by the American Law Institute in 1977 (from which the standard derives its name). The restatement standard generally permits a negligence claim against an accountant to be asserted by any person whom the accountant knew at the time he or she issued the report would be relying upon the report. Like the privity standard, the restatement standard has received differing interpretations by the courts of those states that have adopted it. For example, in most of the 23 states that have adopted the restatement standard, a member of a limited class of foreseeable users of the firm's financial statements is permitted to assert a negligence claim. However, in a few states that have adopted the restatement standard, only specific individuals and entities whose reliance on the accountant's report was actually foreseen may assert such a claim. There must be a defined individual or group for whose benefit the accountant knows its work product is being created and supplied. The restatement standard, though labeled a middle ground, is probably closer to the near-privity approach because it defines a class of non-clients who may maintain an action and defines the type of transaction with respect to which the accountants may be held liable.

Exhibit 2-1

Liability to Third Parties[a]

Privity	Restatement	Reasonably Foreseeable
Arkansas	Alabama	Mississippi
Connecticut	Alaska	Wisconsin
Idaho	Arizona	
Illinois	California[b]	
Indiana	Florida	
Kansas	Georgia	
Louisiana	Hawaii	
Maryland	Iowa	
Montana	Kentucky	
Nebraska	Massachusetts	
New Jersey	Michigan	
New York	Minnesota	
Pennsylvania	Missouri	
Utah	New Hampshire	
Virginia	North Carolina	
Wyoming	North Dakota	
	Ohio	
	Rhode Island	
	South Carolina	
	Tennessee	
	Texas	
	Washington	
	West Virginia	

Notes:

[a] This exhibit presents the current status in each state as of the date this course was written. In the states not listed, the issue of the accountant's liability has not yet been resolved. Due to the ever-changing nature of this information, accountants should consult a qualified attorney before making any decisions based on the third-party liability approach applied in a particular jurisdiction.

[b] In California, claims not based upon misrepresentations are governed by a privity standard.

* * *

States That Follow the Foreseeability Standard. Two states (as listed in Exhibit 2-1) have adopted the *foreseeability standard*. This standard permits any person whose reliance upon the accountant's report could have been reasonably foreseen at the time the report was issued to assert a claim based upon a negligence standard. This is an extremely broad standard and makes the accountant vulnerable to negligence claims by a very broad spectrum of potential claimants. The foreseeability standard was also adopted by the courts in California and New Jersey. The California ruling was later overturned by the California Supreme Court in *Bily v. Arthur Young & Co.* and the New Jersey ruling was reversed when the New Jersey legislature enacted a privity statute.

Privity and Related Defenses May Protect a Firm against a Negligence Claim, but Not Fraud

The privity doctrine only controls who may assert a claim based upon negligence. No state has any rule limiting who may assert a claim for fraud. However, in order to prove fraud, the plaintiff must not only prove that the financial statements were materially misstated, but also that the CPA firm either knew that the statements were materially incorrect or conducted its engagement in such a reckless fashion that it showed a lack of concern as to the accuracy of the resulting report.

Protecting the Privity Defense or Related Defenses

A privity-related defense is an extremely important defense, as it permits a defendant CPA firm to have the case dismissed on motion at the outset of the litigation, thereby avoiding the time and expense normally incurred during the course of even successfully defended litigation. Because it is such a powerful defensive tool, a CPA firm should be vigilant in preserving the defense in as many cases as possible.

Because the privity doctrine (discussed earlier in this section) prevents most nonclients from asserting negligence claims against accountants, in an effort to avoid the higher burden of proof associated with fraud claims, their attorneys will frequently include in their complaints a cause of action (claim) for breach of contract, alleging that their client is an "intended beneficiary" of the accounting firm's engagement by its client. While it is normally more difficult for a non-client to establish that it is an "intended beneficiary" than it is to satisfy the privity requirement, there are a number of court decisions which hold that an agreement by an accountant's client to furnish the plaintiff with a copy of its compiled or reviewed financial statements constitutes evidence that the plaintiff is an intended beneficiary of the accountant's engagement.

To avoid this result, it is suggested that accounting firms insert an additional provision in their engagement letters making it clear that only the client is the intended beneficiary of the accounting firm's engagement. Such language might read as follows:

> This engagement is solely for the benefit of Accounting Firm and Client and no other person shall be entitled to enforce the terms of this agreement.

This statement should be sufficient to negate an inference that a plaintiff is an "intended beneficiary" of the accountant's engagement, even in those situations in which the only reason the accountant's client sought an accountant's report was to satisfy its obligation to provide the plaintiff (or a class of persons of which the plaintiff was a member) with an accountant's report covering its financial statements. Thus, it should prevent nonclients from circumventing the privity doctrine in this fashion.

Similarly, some courts have held that by addressing a compilation or review report to the shareholders and/or directors of the client entity, an accounting firm creates an inference that it intends all such persons to rely on its report precluding a successful motion to dismiss or a motion for summary judgment. Accordingly, it is more prudent to simply address financial statement reports to the client entity. This will protect the firm's potential reliance on the privity defense.

Because a privity defense or a related defense represents a formidable defense against client creditor claims, banks and other financial institutions constantly seek ways to circumvent this defense. In this connection, many banks and other institutional creditors have adopted procedures whereby they regularly notify CPA firms of their intended reliance upon the firm's financial statement reports. Some financial statement users even ask CPA firms to acknowledge in writing that they are aware that a third party will rely on the accountant's report. In fact, the New Jersey privity statute requires banks to obtain such letters as a precondition to asserting a negligence claim. CPAs should rarely issue such third-party privity letters. When a CPA is notified by a third party that it intends to rely on the accountant's report, whether the notice was received via telephone or in writing, the CPA firm must carefully assess whether and how it should respond.

In the two states that have adopted the Foreseeability Standard, the privity defense is not likely to pose any barrier to a negligence claim. Firms practicing in these states should concentrate their efforts on establishing the "no reasonable reliance" defense discussed in later in this section.

Those CPA firms operating in one of the states that have adopted the Restatement Standard must first determine whether the creditor's notice came before or after the firm issued its report. If the notice came after the issuance of the CPA firm's report, the CPA firm can simply reply that it was not aware of the creditor's intended reliance at the time it performed its engagement so it did not take that reliance into consideration in determining which procedures to perform. In that situation, the CPA firm's report was not prepared for the purpose of determining the client's creditworthiness, and the creditor should take other measures to assure itself of the client's creditworthiness.

Those CPA firms operating in one of the states that have adopted the privity standard should initiate no communications with the creditor. If the creditor's communication is in the form of a letter, the firm should simply discard the letter. If the communication from the creditor comes in the form of a telephone call, the CPA firm should inform the caller that it is the firm's policy not to engage in direct communications with client creditors and then terminate the call.

Many clients will take the position that the only reason they hire a CPA firm is to obtain sufficient financial credibility to maintain relationships with sources of capital. Such clients believe that CPA firms should either accept that responsibility or resign the account. Obviously, the appropriate response is that the CPA firm is retained to provide compilation or review or other services and not to serve as a credit source for its clients or to lend its financial credibility to the client. If a client insists that relationships with its creditors are a necessary part of the CPA firm's role, the CPA firm generally should resign from the account.

There will be situations in which the client will insist that its CPA firm acknowledge its bank's intended reliance upon the firm's report on the client's financial statements, and the firm (after an appropriate assessment of the likelihood of default by the client and the level of fees it expects to receive from the client) will wish to do so. This has proven to be the case with respect to a number of client engagements with bank loans. In response to these requests, CPA firms have written responding letters that include the following:

- An acknowledgment of the bank's intended reliance upon specified financial statement report(s) in connection with a particular loan for a specified amount.
- The inherent limitations of the firm's engagement.
- The importance of the bank's performing customary credit checks and ongoing credit monitoring efforts.

Many banks will draft form letters for the accounting firm to sign to acknowledge its understanding of the bank's intended reliance on the firm's report. Such letters are invariably drafted in an open-ended fashion, covering all past and future reports issued by the firm and any and all loans that the bank shall make. As a result, best practices indicate that these letters should never be signed. The accountant's letter should be very specific, covering only the specific report or reports that have been supplied to the bank and the specific loan (in type and amount) the bank is contemplating. Should the bank later decide to expand its line of credit, it will be required to obtain a second letter or lose its privity status with the firm.

The No Reasonable Reliance Defense

210.46 To recover damages from an accounting firm, a plaintiff must also establish a causal link between the accounting firm's wrongful action and the plaintiff's damages. This usually requires the plaintiff to assert that it reasonably relied on the firm's report. A defense attorney for a CPA firm may sometimes be able to assert that a creditor or investor could not have *reasonably* relied on the CPA firm's report. Such a defense may be appropriate, for example, when the firm only compiled a set of financial statements or prepared a tax return for the client. This defense may even be used when a CPA compiled or reviewed a set of financial statements if the statements are old or if they show that the client's financial condition would not appear to warrant a loan or investment of the magnitude made by the plaintiff. Unlike the privity defense, the "no reasonable reliance" defense is usually not sufficient to obtain a dismissal of the claim at the outset of the case. It may be sufficient, however, to prevent a case from going to trial.

SELF-STUDY QUIZ

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

12. Which of the following statements most accurately describes an issue related to communications with a predecessor accountant?

    a. The successor should not expect access to the predecessor's workpapers.

    b. The successor needs the client's permission to contact the predecessor.

    c. The successor can contact the predecessor if prior period statements need revision.

    d. If the client has frequently changed accountants, it is not appropriate to contact the predecessor.

13. Which of the following CPAs has best dealt with an issue related to a compilation or review engagement?

    a. Ethan does not get professional liability insurance because he only performs tax, compilation, and review engagements.

    b. Felicity makes all her client acceptance decisions based on the profit margin.

    c. Greg accepts a commission fee for referring a customer to one of his review clients.

    d. Hannah is licensed as a CPA in the state where she lives and two others in which she does business.

14. What does the privity document hold?

    a. That only a CPA firm's client can sue a CPA firm for negligence.

    b. Any person the accountant knew would rely on the report can sue for negligence.

    c. Any person whose reliance on the report could be foreseen can assert a negligence claim.

    d. Any person who uses an accountant's report can sue for negligence.

SELF-STUDY ANSWERS

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

12. Which of the following statements most accurately describes an issue related to communications with a predecessor accountant? **(Page 190)**

    a. The successor should not expect access to the predecessor's workpapers. [This answer is incorrect. The successor may wish to obtain access to the predecessor's workpapers. Ordinarily, workpapers relating to matters of continuing accounting significance and those relating to contingencies should be made available by the predecessor, unless there is some valid business reason, such as unpaid fees.]

    b. The successor needs the client's permission to contact the predecessor. [This answer is correct. As required by the Code, a successor accountant should obtain the client's permission if he decides to make inquiries of the predecessor, and the client should authorize the predecessor to respond fully. If the client will not permit communication, the successor should consider withdrawing from or not accepting the engagement.]

    c. The successor can contact the predecessor if prior period statements need revision. [This answer is incorrect. When, during the course of his compilation or review engagement, the successor accountant becomes aware of information that leads him to believe the prior-period financial statements reported on by the predecessor accountant require revision, a successor accountant may request that the client communicate that information not the predecessor accountant. The successor should not make that communication himself.]

    d. If the client has frequently changed accountants, it is not appropriate to contact the predecessor. [This answer is incorrect. The client frequently changing accountants is actually a circumstance in which is it desirable for the successor accountant to contact the predecessor accountant prior to accepting the engagement.]

13. Which of the following CPAs has best dealt with an issue related to a compilation or review engagement? **(Page 194)**

    a. Ethan does not get professional liability insurance because he only performs tax, compilation, and review engagements. [This answer is incorrect. Claims arising from compilation engagements alone comprise 6% of all malpractice claims filed each year. CPA firms that do only tax, compilation, and review work should never assume that their malpractice risk is immaterial, as it is not unusual for small CPA firms with no audit practice to be hit with claims seeking in excess of $1 million. Therefore, Ethan needs to develop a system designed to avoid liability claims, and one of those defensive measures should be obtaining professional liability insurance.]

    b. Felicity makes all her client acceptance decisions based on the profit margin. [This answer is incorrect. Risk avoidance is an important part of loss prevention, and it is something that all CPAs, such as Felicity, and CPA firms need to consider. Risk avoidance includes a variety of loss prevention techniques that focus on limiting the types of clients and engagements the firm accepts. Gone are the days when CPA firms made client acceptance decision solely on the basis of whether the engagement could be performed profitably. Today, before accepting an engagement, CPA firms must not only examine the economics of servicing the client but also the potential liability risks posed by the engagement. The requirements of QC 10 need to be met, as well.]

    c. Greg accepts a commission fee for referring a customer to one of his review clients. [This answer is incorrect. ET 1.520.001.01 of the Code prohibits members from accepting commissions and referral fees from clients for whom the member performs (1) examinations of prospective financial information; (2) audits of financial statements; (3) reviews of financial statements; or (4) compilations of financial statements, unless the report discloses a lack of independence. Therefore, Greg's acceptance of this commission is a breach of the Code.]

d. Hannah is licensed as a CPA in the state where she lives and two others in which she does business. [This answer is correct. State legislatures and the courts have determined that it is in the public interest to regulate professional services offered by CPAs. Accountancy laws governing the licensing of certified public accountants and prescribing entry requirements for those who wish to hold themselves out to the public to practice accounting have been enacted in all fifty states, District of Columbia, Puerto Rico, Guam, and Virgin Islands. CPAs should also consider applicable state board of accountancy licensing and registration requirements for the firm and its personnel. Most states require firms to possess a firm license. Therefore, it is likely appropriate for Hannah to hold multiple licenses.]

14. What does the privity document hold? **(Page 195)**

a. That only a CPA firm's client can sue a CPA firm for negligence. [This answer is correct. The law has long limited who can assert claims against a CPA firm based upon the CPA firm's professional negligence. This process began in 1931 with the decision of the New York State Court of Appeals in *Ultramares v. Touche* in which the court held that a CPA firm could only be sued on a negligence theory by those persons with whom the CPA firm had entered into a contractual or privity relationship (i.e., the CPA firm's client). Sixteen states follow the privity rule as originally described or a more modern version of that doctrine described by the New York Court of Appeals in its 1985 decision in *Credit Alliance v. Arthur Andersen*. In that case, the court held that persons who may sue an accounting firm on a negligence standard include not only the CPA firm's clients but also those persons the firm knew would be relying upon the firm's report and with whom the firm maintained a relationship similar to that of an accountant-client relationship. This would include banks and other creditors of the CPA firm's client with whom the accounting firm had direct dealings relating to the extension of credit to the client.]

b. Any person the accountant knew would rely on the report can sue for negligence. [This answer is incorrect. Twenty-three states have adopted the *restatement standard*, which is the test recommended in the *Restatement (Second) of the Law of Torts* published by the American Law Institute in 1977. The restatement standard generally permits a negligence claim against an accountant to be asserted by any person whom the accountant knew at the time he or she issued the report would be relying upon the report.]

c. Any person whose reliance on the report could be foreseen can assert a negligence claim. [This answer is incorrect. Two states have adopted the *foreseeability standard*. This standard permits any person whose reliance upon the accountant's report could have been reasonably foreseen at the time the report was issued to assert a claim based upon a negligence standard.]

d. Any person who uses an accountant's report can sue for negligence. [This answer is incorrect. None of the standards about who can sue a CPA or CPA firm for negligence is this broad or allows this many potential claimants.]

THE BASICS OF QUALITY CONTROL, PEER REVIEW, AND THE ETHICS STANDARDS

The AICPA and the state societies of CPAs attempt to maintain self-regulation of firm quality and professionalism through various committees, such as ethics committees and practice review committees. The AICPA's Quality Control Standards, Peer Review Program, and *Code of Professional Conduct*, are discussed in the following paragraphs. This section is intended to provide a high-level overview of the AICPA's quality control and peer review standards. *PPC's Guide to Quality Control—Compilation and Review* discusses quality control and peer review in more detail.

As a reminder, the Public Company Accounting Oversight Board (PCAOB) has the authority to establish auditing, quality control, ethics, independence, and other standards relating to audits and to conduct quality reviews of accounting firms that have issuer clients.

Quality Control Standards

QC 10 establishes standards and provides guidance for a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. The purpose of a quality control system is to promote quality in performing accounting and auditing engagements. A firm's system of quality control is a system designed to provide the firm with reasonable assurance that (a) the firm and its personnel are complying with professional standards and legal and regulatory requirements, and (b) that reports issued by the firm are appropriate in the circumstances. In developing and maintaining its quality control system, a firm establishes policies designed to achieve the objectives associated with obtaining reasonable assurance and procedures required to implement and monitor compliance with those policies. In the context of QC 10 , *reasonable assurance* is a high level of assurance, but not absolute assurance.

The firm's quality control system should consist of policies and procedures. The nature of the policies and procedures the firm develops to obtain reasonable assurance and comply with the requirements of QC 10 will depend on various factors, such as the following:

- The size of the firm.
- The operating characteristics of the firm, for example—
  - Types of services provided.
  - Types of industries served.
  - Number of partners.
  - Number of professional personnel.

Professional Requirements. QC 10.08 establishes requirements regarding the firm's degree of responsibility it has in complying with the requirements of the standard. The firm's professional requirements as defined in the standard are designated into two categories:

- *Unconditional Requirements.* Unconditional requirements are those the firm must follow in all cases if the circumstances apply to the requirement. These requirements use the word *must*.
- *Presumptively Mandatory Requirements.* Firms are also expected to comply with presumptively mandatory requirements if the circumstances apply to the requirement; however, in rare situations, a departure from the requirement is allowed if the firm documents the justification and how alternative procedures that were performed were sufficient to achieve the objectives of the requirement. Presumptively mandatory requirements are identified by the word *should*. If the standard uses the words *should consider* for a procedure, the consideration of the procedure is presumptively required.

Elements of a Quality Control System. QC 10.17 states that the firm's system of quality control should incorporate policies and procedures that address each of the following QC elements:

- *Leadership Responsibilities for Quality Within the Firm (Tone at the Top).* The firm has policies and procedures to promote an internal culture recognizing that quality is essential in performing engagements.
- *Relevant Ethical Requirements.* The firm and its personnel comply with relevant ethical requirements.
- *Acceptance and Continuance of Client Relationships and Specific Engagements.* The firm undertakes or continues only client relationships and engagements in which the firm (a) considers the client's integrity and does not have information that would indicate the client lacks integrity; (b) determines the firm has the competence, capabilities, and resources to perform the engagement; and (c) determines the firm can comply with legal and regulatory requirements.
- *Human Resources.* The firm has sufficient personnel with the competence, capabilities, and commitment to ethical principles to (a) perform engagements in accordance with professional standards and applicable legal and regulatory requirements, and (b) enable the firm to issue reports that are appropriate in the circumstances.
- *Engagement Performance.* Work performed by engagement personnel consistently complies with applicable professional standards and regulatory requirements, and the firm issues reports that are appropriate in the circumstances.
- *Monitoring.* The policies and procedures established by the firm for the other elements of quality control are relevant, adequate, and operating effectively.

Relationship of SSARS to Quality Control Standards. Statements on Quality Control Standards relate to the conduct of a firm's entire accounting practice. SSARS relate to the conduct on individual preparation, compilation, and review engagements. The quality control policies and procedures that a firm adopts could affect the conduct of an individual engagement and affect the firm's overall accounting practice. However, deficiencies or instances of noncompliance with a firm's quality control policies and procedures do not necessarily indicate that an engagement was not performed in accordance with professional standards or that the accountant's report, if applicable, was not appropriate.

Documentation and Communication of the Firm's QC Policies and Procedures. QC 10.18 requires that the firm document its QC policies and procedures. Matters such as the nature of the firm's practice, its size, and its structure may be considered in determining the *extent* of documentation of the firm's QC policies and procedures. Documentation of the policies and procedures of a single-office firm with a small number of partners and staff might not be expected to be as extensive as those of a large, multi-office firm.

QC 10 does not require the firm to have a formal quality control policies and procedures *document*; instead, the standard indicates only that the firm's QC policies and procedures be *documented*. Thus, the QC standard allows the firm to have flexibility and latitude in determining the documentation method that best suits their individual practice and circumstances.

In addition to documenting the firm's QC policies and procedures, QC 10.18 indicates that the firm should communicate its QC policies and procedures to firm personnel. That communication is not required to be in writing, although written communication is preferable. An effective firm communication of its QC policies and procedures, as described in QC10.A2, generally incorporates the following:

- A description of the policies and procedures and the objectives they achieve.
- A message that each person is responsible for maintaining quality, as well as being familiar with the policies and procedures and complying with them.
- Comments stressing the importance of receiving feedback on how the QC system is operating and encouraging staff to communicate their concerns on quality control issues.

This documentation and communication requirement is applicable to firms that have a compilation and review practice, as well as firms that have an accounting and auditing practice, and requires those firms to undergo a peer review at least once every three years. As a result, such firms should have in place a quality control system that will withstand such a review or risk termination of firm membership in the program, individual memberships in the AICPA, and, in some states, loss of their licenses to practice.

Quality control materials (QCM) provide guidance to assist firms in performing and reporting in conformity with professional standards and may include, but are not limited to, engagement aids (including accounting and auditing manuals), checklists, questionnaires, work programs, electronic accounting and auditing tools, and similar materials designed to be used by accounting and auditing engagement teams. When designing the firm's quality control policies and procedures, the firm should indicate the QCM that are being used, or make reference to the firm's accounting manuals that contain the firm's QCM.

In conjunction with its Enhancing Audit Quality Initiative, the AICPA recently developed and released e-versions of its previously published Practice Aid, Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice (the AICPA Practice Aid). The information is currently available at no charge on the AICPA's website at **www.aicpa.org/InterestAreas/frc/pages/EnhancingAuditQualityPracticeAid.aspx.** The redeveloped AICPA Practice Aid provides illustrative examples of various types of policies and procedures a firm may consider when developing its system of quality control under the guidelines of QC 10. Illustrative examples of quality control documents are provided for two hypothetical firms:

- Small-and medium-sized firms.
- Sole practitioner.

The redeveloped AICPA Practice Aid is the joint effort of the Peer Review Board and the ASB, and while not authoritative, it may be a beneficial resource for use by firms when drafting QC policies and procedures. The redeveloped AICPA Practice Aid includes tips, warnings, and reminders to help firms implement their QC policies and procedures.

In addition, *PPC's Guide to Quality Control—Compilation and Review* can assist firms in this task. It illustrates suggested policies and procedures that address the elements of quality control listed in QC 10.

Establishing Criteria for Engagement Quality Control Reviews (EQCR). Firms are required to establish criteria as part of their QC policies and procedures for determining when an EQCR should be performed. In establishing criteria for performance of an EQCR, the structure and nature of the firm's practice are important. QC 10.A41 indicates that such criteria may include considerations such as the following:

- The nature of the engagement, including whether it involves a matter of public interest.
- Whether unusual circumstances or risks have been identified relating to the engagement, engagement service type, or industry.
- Whether laws or regulations require an engagement quality control review to be performed.

If no engagements meet the criteria established by the firm for review, no EQCRs are required to be performed.

The structure and nature of the firm's practice are important factors in establishing criteria to consider when determining which engagements are to be subject to an EQCR. Accordingly, it is a best practice for firm management to begin the process of developing EQCR policies and procedures by considering the firm's unique structure and nature. Firm structure includes the size of the firm, the number of partners in the firm, etc. The nature of the firm includes the types of services the firm performs and how those services make up the total engagements of the firm. For example, does the firm provide an extensive line of services including review, compilation, and attestation engagements?

Firms define engagement quality control review criteria based on the firm's unique circumstances (that is, structure and nature). Accordingly, some firms may establish criteria that result in more EQCRs being performed than other firms. For example, a compilation and review firm with a larger tax practice and a smaller accounting practice may designate that all reviews exceeding an 80-hour time budget have an EQCR performed. For that particular firm, because the firm offers a variety of services overseen by multiple partners, some of whom perform both review and tax services, there may be a more pressing need to have EQCRs performed on a larger number of review engagements. Alternatively, a firm that performs a significant number of reviews may feel more confident in its ability to follow established review guidance because all of its partners routinely perform reviews as a matter of course. Thus, that firm may designate only review engagements that it considers to be high-risk (as defined by the firm) for EQCR. The preceding discussion indicates that different firms may treat the same engagement differently for purposes of establishing engagement quality control review criteria. The key point is that EQCR criteria are as unique as the firm.

For each type of service provided, the firm may consider a different set of EQCR criteria. In other words, the criteria established for review engagements may differ significantly than for other types of attest engagements. As mentioned earlier in this section, QC 10.A41 suggests that when establishing criteria for EQCR, firms consider, for example, the nature of the engagement, unusual circumstances or risks of the engagement, and whether other laws or regulations impact EQCR requirements. Additionally, for most firms, the appropriate criteria consist of a mix of considerations and not merely one criterion. The following items further represent the types of situations that may be considered in establishing EQCR criteria:

- Third-party use of the report, such as to the client's lender for financing purposes.
- High profile clients, for example, well-known individuals or entities in the local community and those involving a matter of public interest.
- Clients that are individually significant to the firm's revenues or to partner compensation, representing an undue influence threat.
- Entities subject to governmental or regulatory requirements.
- New types of service for the firm; for example, the firm begins to offer prospective financial information services.
- Engagements for an entity that has situations the firm rarely encounters, such as joint ventures.
- Engagements that required consultation with third parties.
- New firm partners.
- New or complex specialized industries, especially engagements where the firm's practice is limited and the firm's personnel have little or no experience.
- First-time clients.
- Client entities without competent or experienced accounting personnel.
- Client entities with substantial fraud risk factors.
- Client entities with significant related-party relationships or transactions.
- Clients that have experienced material misstatements during current or previous engagements.
- Engagements for which a familiarity threat may exist.
- Engagements where the acceptance and continuance decision caused reason for concern (even though the firm resolved the initial concern).

Any circumstance that creates an unusual or a higher level of engagement risk ought to be considered in establishing EQCR criteria. Whenever an engagement is subject to a heightened level of risk, the firm may consider it prudent to have a second pair of eyes review the engagement. Regardless of whether a particular engagement meets the firm's stipulated EQCR criteria, any engagement may be selected for EQCR based on current year risk during engagement performance. However, the reverse situation does not hold true. That is, a firm may not choose to opt-out of performing an EQCR when an engagement meets the established EQCR criteria.

Because EQCR criteria is based on each firm's unique circumstances, firms ought to consider revising the established EQCR criteria when firm circumstances change. The firm's quality control system needs to be a dynamic system that changes as the firm changes.

Engagement Level Quality Control Requirements of AR-C 60

AR-C 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*, provides general principles for firms to follow when performing an engagement under the SSARS. Among other things, it includes engagement-level quality control requirements that address certain of the quality control elements of QC 10.

The responsibility to ensure compliance with these engagement-level quality control requirements is primarily placed on the engagement partner. However, the related application guidance indicates that the engagement team also has responsibility to implement engagement-level quality control procedures. In meeting the requirements, the engagement team may rely on the firm's quality control system unless the firm or other parties have indicated that it is inappropriate to do so. The following discussion presents an overview of the engagement level quality control requirements of AR-C 60. For more information about the engagement level quality control requirements, related guidance, and how these requirements relate to the quality control elements of QC 10, see *PPC's Guide to Quality Control—Compilation and Review*.

Engagement Partner and Team Competence. AR-C 60.20 provides an overarching requirement for the engagement partner to possess appropriate competencies and capabilities that will allow him or her to perform the engagement in accordance with the SSARS. AR-C 60.21(d)(ii) also requires that the engagement partner be satisfied that the engagement team possesses appropriate competence and capabilities to (a) perform the SSARS engagement as required by professional standards and applicable legal and regulatory requirements and (b) issue a SSARS report, if applicable, that is appropriate in the circumstances.

Responsibility for Quality. AR-C 60.21(a) requires the engagement partner to take responsibility for the overall quality of each SSARS engagement to which he or she is assigned. AR-C 60.A38 stresses that engagement teams have a responsibility to implement quality control procedures that are appropriate to the engagement. Additionally, the engagement partner needs to emphasize the fact that quality is essential when performing an engagement under the SSARS.

Acceptance and Continuance. AR-C 60.21(d)(i) requires the SSARS engagement partner to be satisfied that the engagement and client relationship acceptance and continuance process was appropriately performed. The engagement partner is also required to consider whether information presented or discovered indicates a lack of management integrity. AR-C 60.A45 further states that if the engagement partner doubts the integrity of management such that the proper performance of the engagement may be affected, not accepting the engagement is appropriate, unless acceptance is required by law or regulation.

Engagement Performance. Under AR-C 60.21(b), the engagement partner is responsible for directing, supervising, planning, and performing the engagement to comply with all applicable professional standards and ethical and legal requirements. AR-C 60.21(c) indicates that the engagement partner should assume the responsibility for the appropriateness of the accountant's report in the circumstances of the particular engagement.

AR-C 60.21(d)(iii) specifies that the engagement partner should take responsibility for ensuring that appropriate engagement documentation is maintained for all engagements performed under the SSARS. This requirement is included in a list of requirements directing the engagement partner to ensure that SSARS engagements are performed in accordance with the firm's quality control policies and procedures. Thus, the requirement is not specific or limited to only assembly of engagement documentation, but is broader, encompassing engagement documentation in totality.

AR-C 60.22 requires the engagement partner to inform the firm promptly of any information received after the acceptance or continuance of an engagement, that had the information been known earlier, would have caused the firm to decline the engagement.

Complying with Ethical Requirements. AR-C 60.24 requires the engagement partner to be alert throughout the engagement for evidence of noncompliance by anyone on the engagement team. If matters come to the engagement partner's attention that anyone on the engagement team is not in compliance with relevant ethical requirements, the engagement partner, in consultation with others in the firm, should determine an appropriate course of action.

Monitoring. AR-C 60.23 indicates that an effective monitoring process is designed to provide reasonable assurance that a firm's quality control policies and procedures are relevant, adequate, and operating effectively. The engagement partner should consider the results of the firm's monitoring process and whether any quality control system deficiencies noted during the most recent monitoring could potentially affect the engagement.

Peer Review Standards

Applicability of Peer Review Requirements. If a CPA firm has an accounting and auditing practice as defined by the Peer Review Standards, the firm should enroll in the AICPA Peer Review Program or the peer review program of the National Peer Review Committee (National PRC). Compilation and review firms generally enroll in the AICPA Peer Review Program because of the types of engagements performed. If the firm does not perform accounting and auditing services as defined by the Peer Review Standards or only performs SSARS preparation engagements, the firm is not required to have a peer review. Individual CPAs in non-CPA owned firms are required to enroll in a peer review program if they perform SSARS compilations and issue compilation reports.

A firm can join the AICPA Peer Review Program by completing the AICPA's Peer Review Program Enrollment Form and submitting it to the AICPA. That form can be obtained from the AICPA website at **www.aicpa.org/InterestAreas/PeerReview/Resources/PeerReviewForms/DownloadableDocuments/enroll900.pdf** or from the administering entities. To enroll in the AICPA Peer Review Program, at least one partner of the firm must be a member of the AICPA and the ownership of the firm must be in compliance with Council resolutions as outlined at ET Appendix B. It is important for a firm to understand that enrollment in the AICPA Peer Review Program is required before the firm can schedule its initial peer review. For firms that are not members of the AICPA, enrollment in a peer review program is still generally required to obtain and maintain the firm's state license. Those firms enroll in a peer review program through their state society, and those state societies generally follow the AICPA Peer Review Program.

The Code requires members to practice in firms that have quality control procedures for ensuring that services are competently delivered. The bylaws of the AICPA include a requirement at BL 2.2.3 and BL 2.3.4 that persons engaged in *public practice* (the practice of public accounting) as an owner, or as an employee who has been licensed as a CPA for more than two years, either are—

a. practicing in a CPA firm that is enrolled in an AICPA-approved practice monitoring program if the firm performs services that are within the scope of the AICPA's practice monitoring standards and the firm issues reports purporting to be in accordance with the AICPA professional standards, or

b. if authorized by Council, are themselves enrolled in such a program.

Practice monitoring programs help protect the public interest in the quality of accounting, auditing, and attestation services performed by public accounting firms. Additionally, most state boards of accountancy require licensees to undergo practice monitoring, also known as compliance assurance at the state level, to practice in their state, regardless of whether the firm or its personnel are AICPA members.

The types of engagements subject to the AICPA practice monitoring requirement are defined in both the Peer Review and QC standards in the definition of the term *accounting and auditing practice*. The Peer Review Standards (PR 100.06) state that an *accounting and auditing practice* consists of all engagements performed under the SASs; SSARSs (excluding for those engagements for which SSARS has provided an exemption); SSAEs; *Government Auditing Standards* (the Yellow Book) issued by the GAO; and PCAOB standards. (However, engagements subject to PCAOB permanent inspection are not included in the scope of the AICPA program.)

QC 10.13 defines an *accounting and auditing practice* as one that performs audit, attestation, compilation, review and any other services for which standards have been promulgated by the ASB or ARSC under the *General Standards Rule* (ET 1.300.001.01) or the *Compliance With Standards Rule* (ET 1.310.001.01), of the Code. Although standards for other engagements may be promulgated by other AICPA technical committees, engagements performed in accordance with those standards are not encompassed in the definition of an *accounting and auditing practice*.

Although there are subtle differences in the wording of the definitions of an accounting and auditing practice as found in the Peer Review Standards and QC 10, it is the AICPA Peer Review Board's intent that the definitions cover the same types of engagements. Accordingly, the types of engagements subject to a firm's peer review are the same types of engagements that should be included in a firm's QC system.

Are SSARS Financial Statement Preparation Engagements Subject to Peer Review? The answer to the question of whether financial statement preparation services performed under the SSARS (AR-C 70) are subject to peer review is "maybe." To further explain, the Peer Review Standards (PR 100.07) indicate that when a firm's highest level of accounting and auditing service performed is a financial statement preparation, such firms are not required to enroll in the AICPA Peer Review Program and undergo peer review. However, the Peer Review Interpretations go on to state that when the firm either elects to enroll in the program or is already enrolled because of the other types of engagements it performs, the firm's preparation engagements *will* be subject to peer review. Also, firms should be aware that state board requirements may be more stringent. Thus, while the AICPA does not require peer review of firms that perform preparation engagements as their highest level of service, practice monitoring requirements of state boards of accountancy may stipulate that firms performing SSARS engagements (which would include preparation services) must have peer reviews. In such circumstances, firms performing only preparation engagements would be subject to peer review. Accordingly, firms need to check with their state boards of accountancy.

Types of Reviews. The Peer Review Standards provide for two types of reviews: a *system review* and an *engagement review*. Firms that perform audit engagements under the SASs or *Government Auditing Standards*, examinations under the SSAEs, or engagements under the PCAOB standards as their highest level of service are required to have a system review every three years. Firms that have an accounting and auditing practice, as defined by the Peer Review Standards, but do not perform the types of engagements that require a system review and instead perform only services under the SSARS or the SSAEs (excluding examinations) are required to have an engagement review every three years, but may elect to have a system review. System reviews are not discussed further in this course since compilation and review firms ordinarily do not undergo system reviews. (Undergoing a system review is covered in *PPC's Guide to Quality Control*.) Firms that do not perform any of the services discussed in this paragraph are not required to undergo peer review. Peer Review Standards Interpretation No. 7–2 explains which type of peer review a firm is required to undergo based on its highest level of service provided.

Engagement Reviews. As discussed in the preceding paragraph, compilation and review firms generally undergo a peer review known as an *engagement review*. The objective of an engagement review is to evaluate whether engagements submitted by the firm under review are performed and reported on in conformity with applicable professional standards in all material respects. In an engagement review, the peer reviewer reads the financial statements or information and the related accountant's report submitted by the reviewed firm. The peer reviewer also considers whether certain background information and representations and the applicable documentation required by professional standards, are appropriate.

The peer reviewer does not attempt to evaluate the adequacy of the firm's quality control system. As a result, an engagement review does not involve a review of engagement workpapers (other than engagement documentation discussed below), administrative files or personnel files, personnel interviews, or other procedures. Since an engagement review does not evaluate the firm's system of quality control, an engagement review report is very different from a system review report, which expresses an opinion on the firm's QC system. The engagement review report provides assurance only on the firm's engagements. Engagement reviews are discussed in detail in *PPC's Guide to Quality Control—Compilation and Review*.

During an engagement review, the following procedures are performed by the reviewer:

a. Consideration of the financial statements or information and the related accountant's report on the preparation, compilation, and review engagements performed under SSARS and engagements performed under SSAEs.

b. Consideration of the documentation on the engagements performed via reviewing background and engagement profile information, representations made by the firm, and inquiries.

c. Review of all other engagement documentation required by applicable professional standards.

Selection of Engagements for Review. In selecting the engagements for review, reviewers use the following guidelines established in the Peer Review Standards:

a. One engagement is selected from each of the following types of services performed by the firm:

   (1) Review of historical financial statements (performed under SSARS).

   (2) Compilation of historical financial statements, with disclosures (performed under SSARS).

   (3) Compilation of historical financial statements that omit substantially all disclosures required by GAAP (or a special purpose framework) (performed under SSARS).

   (4) Engagements performed under the SSAEs other than examinations.

b. One engagement is selected from each individual of the firm (generally partners) who is responsible for the issuance of the reports listed in item a.

c. Selection of preparation engagements would be made only in the following instances:

   (1) One preparation engagement with disclosures (performed under SSARS) is to be selected when performed by an individual in the firm who does not perform any engagements included in item (a) or when the firm's only engagements with disclosures are preparation engagements.

   (2) One preparation engagement that omits substantially all disclosures (performed under SSARS) is to be selected when performed by an individual in the firm who does not perform any engagements included in item (a) or when the firm's only omit disclosure engagements are preparation engagements.

   (3) One preparation engagement is to be selected if needed to meet the requirement in item d.

d. Generally, at least two engagements are selected for review.

The criteria listed in items a.-d. are not mutually exclusive. In other words, one of every type of engagement that a partner (or individual if not a partner) performs does not have to be reviewed as long as, for the firm as a whole, all types of engagements noted in item a. performed by the firm are covered. Also, an engagement review does not include tax or consulting services engagements.

The engagements subject to review are those with years (or periods) ended during the year under review. For financial forecasts or projections and agreed-upon procedures engagements, the selection for review generally should be those with accountant's report dates during the year under review. If the current year's engagement has not been completed and a comparable engagement within the peer review year is unavailable, then the prior year's engagement should be reviewed. In addition, if a more recent equivalent (compilation, review, attestation, etc.) engagement for the client has been completed, then the more recent engagement is generally selected.

Procedures Checklists Should Comply with Peer Review and SSARS Standards

Quality Control Materials. An integral part of a firm's QC system is its engagement work programs, checklists, sample confirmations and letters, and other practice aids that help ensure compliance with both authoritative literature and peer review standards. Such systems of practice aids are often referred to as *quality control materials* (QCM).

The checklists presented in *PPC's Guide to Compilation and Review Engagements* are adopted by many firms as their QCM. Likewise, many firms also adopt the checklists and practice aids in PPC's other auditing and accounting manuals as the QCM for their QC systems. During a system review, the review team asks for copies of all QCM used by the firm and whether the firm obtains its QCM from an outside source. If so, the review team will also ask whether the provider of the QCM has undergone a peer review. If not, it is necessary for the peer review team to spend additional time reviewing the appropriateness of the QCM. There is not an evaluation of practice aids in an engagement review, as the focus is on the engagement and not the system of quality control.

However, all firms subject to peer review have responsibilities for the use of quality control materials as stated in the QCM Review Report, most recently updated as of January 1, 2014, as follows:

> Users of the materials and this report should carefully consider the scope of this review. They should also understand the intended uses and limitations of the materials as reflected in their user instructions and related information, as well as the level of explanatory guidance provided by the materials. Users of the materials are responsible for evaluating their suitability and implementing, tailoring, and augmenting the material as appropriate. Therefore, the reliability of the materials is also dependent on the effectiveness of these actions and could vary from user to user. Further, there may be important elements of a quality control system in accordance with the Statements on Quality Control Standards that are not included in the materials that have been subject to this review.

Accordingly, it is important for users of QCM to put procedures in place to ensure those responsibilities are met.

PPC's QCM Have Been Peer Reviewed. PPC's system for developing the checklists and practice aids used in its guides has been reviewed. A peer review report, with a rating of *pass*, is located in the introductory material of *PPC's Guide to Compilation and Review Engagements*. Please direct the peer review team to this report during your peer review. PPC voluntarily elected to undergo this review—

a. To assure users that the QCM in PPC guides conform to both professional standards and quality control standards.

b. To minimize the cost of users' peer reviews.

Issues Noted in Recent Peer Review Reports

Some of the frequently mentioned issues in compilation and review engagements that have been documented as matters for further consideration in recent peer review reports include the following:

- A representation letter is not obtained from the client or is inadequate in a review engagement.
- Failure to include the basic reporting elements and/or report wording does not conform to required SSARS language. Failure to update the report language for SSARS No. 21.
- Engagement letters are missing or contain omissions and errors.
- Compilation reports do not, where applicable, indicate that management has elected to omit substantially all disclosures.
- Accountants' reports fail to indicate the degree of responsibility taken with respect to supplementary information provided in the financial statements.
- Compilation reports are not appropriately modified on an engagement in which the accountant is not independent.
- Review reports are issued on an engagement in which the accountant is not independent.

- Failure to properly modify accountants' reports for a GAAP departure when financial statements do not appropriately present current assets and liabilities in a classified balance sheet.
- Accountants' reports fail to disclose all GAAP departures, such as the failure to include a statement of cash flows or the lack of a tax provision.
- Accountants' reports fail to reference both periods when reporting on comparative financial statements.
- Failure to document expectations when performing analytical procedures and to compare results to those expectations in a review engagement.

Code of Professional Conduct

The AICPA *Code of Professional Conduct* sets forth the fundamental principles of professional ethics that should be followed in a SSARS engagement, including those related to integrity, objectivity, and due care. The Code applies to all individuals who are members of the American Institute of Certified Public Accountants. In addition, certain state CPA societies and state boards of accountancy have incorporated all, or parts of, the AICPA Code into their own rules of conduct.

The AICPA and many state CPA societies have joined together to create the Joint Ethics Enforcement Program (JEEP) in order to permit joint enforcement of their respective codes of professional conduct with respect to a member by means of a single investigation. Accordingly, investigative information is shared between the AICPA and the state CPA societies. In addition, the AICPA Professional Ethics Division receives referrals from the various state licensing boards as well as federal agencies such as the Securities and Exchange Commission and various Inspectors General. However, the AICPA cannot revoke a member's license; only the applicable state licensing board can do that. The AICPA can, however, terminate or suspend an individual's membership.

The Code is divided into three parts that separately apply to members in public practice, members in business, and other members (such as retired and unemployed members), as well as a preface that applies to all members. The Code also provides a numbering system with the reference preface of "ET." In addition, the Code incorporates two broad conceptual frameworks—one for members in public practice and a separate one for members in business. These conceptual frameworks set forth requirements in those situations where the member has identified a threat to compliance with the rules in the Code, and the relationship or circumstance creating the threat is not covered within the Code. Firms can access the online version of the Code at **http://pub.aicpa.org/codeofconduct/Ethics.aspx.**

SELF-STUDY QUIZ

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

15. CPA firms are required to develop a quality control system for their accounting and auditing practices. What piece of professional guidance establishes standards and guidance for this purpose?

    a. The AICPA *Code of Professional Conduct*.

    b. The AICPA Practice Aid, *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

    c. AR-C 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*.

    d. Statement on Quality Control No. 8, *A Firm's System of Quality Control* (QC 10).

16. What element of quality control focuses on the quality of work performed by firm personnel?

    a. Leadership responsibilities for quality within the firm.

    b. Human resources.

    c. Engagement performance.

    d. Monitoring.

17. Which of the following statements best describes engagement quality control reviews (EQCRs)?

    a. A firm is required to perform at least one EQCR per year.

    b. Criteria for performing EQCRs are established by professional standards.

    c. Firms will typically perform the same number of EQCRs in a given year.

    d. A different set of criteria may apply to each type of service.

18. Accountants 'R Us is a CPA firm with an accounting and auditing practice. It is required to do which of the following?

    a. Be enrolled in a practice monitoring program.

    b. Have a system review.

    c. Develop in-house quality control materials (QCM).

SELF-STUDY ANSWERS

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

15. CPA firms are required to develop a quality control system for their accounting and auditing practices. What piece of professional guidance establishes standards and guidance for this purpose? **(Page 204)**

    a. The AICPA *Code of Professional Conduct*. [This answer is incorrect. The AICPA *Code of Professional Conduct* sets forth the fundamental principles of professional ethics that should be followed in a SSARS engagement, including those related to integrity, objectivity, and due care. The Code applies to all individuals who are members of the American Institute of Certified Public Accountants. In addition, certain state CPA societies and state boards of accountancy have incorporated all, or parts of, the AICPA Code into their own rules of conduct. As such, though this is an important piece of guidance for CPA firms, it is not the one devoted to quality control which is described above.]

    b. The AICPA Practice Aid, *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*. [This answer is incorrect. This AICPA Practice Aid provides illustrative examples of various types of policies and procedures a firm may consider when developing its system of quality control under the guidelines of QC 10.]

    c. AR-C 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*. [This answer is incorrect. AR-C 60 provides general principles for firms to follow when performing an engagement under the SSARS. Among other things, it includes engagement-level quality control requirements that address certain of the quality control elements discussed in the guidance that is the correct answer to this question.]

    d. Statement on Quality Control No. 8, *A Firm's System of Quality Control* (QC 10). [This answer is correct. QC 10 establishes standards and provides guidance for a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. The purpose of a quality control system is to promote quality in performing accounting and auditing engagements.]

16. What element of quality control focuses on the quality of work performed by firm personnel? **(Page 205)**

    a. Leadership responsibilities for quality within the firm. [This answer is incorrect. According to QC 10.17, leadership responsibilities for quality within the firm (tone at the top) deals with a firm's policies and procedures to promote an internal culture recognizing that quality is essential in performing engagements. Therefore, this element of quality control focuses more on leadership and firm culture than on the actual work done by personnel.]

    b. Human resources. [This answer is incorrect. As described in QC 10.17, the human resources element of quality control focuses on whether a firm has sufficient personnel with the competence, capabilities, and commitment to ethical principles to (1) perform engagements in accordance with professional standards and applicable legal and regulatory requirements and (2) enable the firm to issue reports that are appropriate in the circumstances. Therefore, this element of quality control focuses on the personnel themselves, not the work they performed.]

    c. Engagement performance. [This answer is correct. The engagement performance element of quality control, as discussed in QC 10.17, focuses on whether the work performed by engagement personnel consistently complies with applicable professional standards and regulatory requirements and that the firm issues reports that are appropriate in the circumstances.]

    d. Monitoring. [This answer is incorrect. Per QC 10.17, this element of quality control ensures that the policies and procedures established by the firm for the other elements of quality control are relevant, adequate, and operating effectively. Therefore, monitoring focuses more on the system of quality control itself than the work performed.]

17. Which of the following statements best describes engagement quality control reviews (EQCRs)? **(Page 207)**

    a. A firm is required to perform at least one EQCR per year. [This answer is incorrect. If no engagements meet the criteria for review, no EQCRs are required to be performed.]

    b. Criteria for performing EQCRs are established by professional standards. [This answer is incorrect. Firms are required to establish criteria as part of their QC policies and procedures for determining when and EQCR should be performed. Therefore, choosing the criteria falls to the firm and is not specifically stipulated in the professional guidance.]

    c. Firms will typically perform the same number of EQCRs in a given year. [This answer is incorrect. EQCR criteria are based on the firm's unique circumstances (that is, structure and nature). Accordingly, the individualized criteria may result in more EQCRs being performed for some firms and less for other firms.]

    d. A different set of criteria may apply to each type of service. [This answer is correct. For each type of service provided, the firm may consider a different set of EQCR criteria. In other words, the criteria established for review engagements may differ significantly from the criteria established for compilation engagements or the criteria established for other types of engagements.]

18. Accountants 'R Us is a CPA firm with an accounting and auditing practice. It is required to do which of the following? **(Page 209)**

    a. Be enrolled in a practice monitoring program. [This answer is correct. Per the AICPA *Code of Professional Conduct*, persons engaged in *public practice* as an owner or as an employee who has been licensed as a CPA for more than two years are required to either (1) practice in a CPA firm that is enrolled in an AICPA-approved practice monitoring program if the firm performs services that are within the scope of the AICPA's practice monitoring standards and the firm issues reports purporting to be in accordance with AICPA's professional standards, or (2) if authorized by Council, are themselves enrolled in such a program. The types of engagements subject to AICPA practice monitoring requirements are defined in both the Peer Review and QC standards in the definition of the term *accounting and auditing practice.* Therefore, to be compliant with the appropriate standards, Accountants 'R Us will need to be part of a practice monitoring program.]

    b. Have a system review. [This answer is incorrect. The Peer Review Standards provide for two types of reviews: a *system review* and an *engagement review*. The type of engagements Accountants 'R Us performs as part of its accounting and auditing practice will determine the type of review that may be appropriate for the firm.]

    c. Develop in-house quality control materials (QCM). [This answer is incorrect. An integral part of a firm's QC system is its engagement work programs, checklists, sample confirmations and letters, and other practice aids that help ensure compliance with both authoritative literature and peer review standards—often called QCM. However, firms are not required to develop QCM in-house. Accountants 'R Us could choose to adopt or adapt checklists from third-parties, such as the PPC guides.]

ACCOUNTING SOFTWARE FOR COMPILATION AND REVIEW ENGAGEMENTS

Introduction

As previously discussed, many compilation and review engagements include various accounting services such as preparing a general ledger, recording journal entries, processing payroll, etc. In fact, providing accounting services and compiled or reviewed financial statements is a common engagement for many practitioners. For example, the product delivered to the client often takes the form of an accountant's report, along with the compiled or reviewed financial statements and general ledger. Many firms utilize accounting software to perform these compilation and review engagements. For example, using the appropriate accounting software, accountants can generate presentation quality financial statements (including footnotes) along with the appropriate accountant's compilation or review report as a byproduct of the accounting services they perform for their client. However, due to the numerous accounting software packages available, it can be difficult for an accountant to select the accounting software that best meets his or her needs. The following section explains what accounting software does, the various types of accounting software, and ways to choose the appropriate accounting software.

What Accounting Software Does. Numerous accounting software programs are available, each capable of handling a variety of tasks. Those tasks include—

- Recording cash receipts and disbursements.
- Maintaining accounts receivable and accounts payable records.
- Recording payroll transactions and producing tax information (e.g., W-2s, 941s, 944s, 1099s, etc.).
- Recording journal entries.
- Generating financial statements.
- Producing an accountant's report on the financial statements.

Types of Accounting Software. Depending on their features, accounting software programs can be loosely classified as either general ledger (G/L) packages or write-up packages.

- G/L packages are integrated accounting software packages designed for active accounting processing (including such functions as generating sales invoices, checks, etc.).
- Dedicated write-up packages are written specifically with write-up engagements in mind. They generally are designed for after-the-fact accounting and include reporting features not found in G/L packages.

The following paragraphs discuss each type of software package in more detail.

General Ledger Packages. G/L packages are integrated accounting programs. That is, the G/L software package often is linked with other modules or programs to comprise an entire accounting system. For example, an integrated system might include various modules for accounts receivable, accounts payable, inventory, and payroll. In such instances, the transactions entered are not only posted to the G/L but produce subsidiary ledgers for those accounts as well. The following are some of the features of a typical G/L package.

- *Client Setup.* The user enters key client data and accounting preferences, such as year-end dates, accounting method, and equity accounts.
- *Account Setup.* A chart of accounts is developed by assigning account numbers and descriptions. Systems vary in the number and types of characters allowed in the account number. Some products force users to select account numbers within a certain range, based on the account's financial statement classification. For example, the software might require that current asset accounts have numbers between 1000 and 1999.

- *Subsidiary Modules.* For many G/L packages, users can buy add-on modules for major accounts and activities such as accounts receivable, accounts payable, inventory, and payroll. Although add-on modules are purchased separately, they link directly with the G/L. Consequently, transactions can be recorded in the G/L directly or through the subsidiary modules.

- *General Journal Entries.* General journal entries (adjustments) are usually entered in a separate journal. Explanations for entries are limited in most products. Journals of activity can be printed and summarized by account.

- *Posting and Period Closing.* Transactions and journal entries can be entered when desired. After the entries for the period are entered, the period is closed (zeroed) and a new one is set up. Special routines are provided for closing the year-end and updating the retained earnings accounts. Transaction detail is normally lost after a year is closed.

- *Reports.* Most packages print G/Ls and subsidiary journals. They also print financial statements, although the options for format and degree of detail may be limited. Many add-on modules generate special reports such as aged accounts receivable and perpetual inventory lists.

Write-up Packages. Like G/L packages, write-up software allows the user to record transactions and generate financial statements. However, these packages have several features suited to the special needs of write-up practices, such as the following:

- *Multiple Client Access.* While many G/Ls are designed to handle only one business, write-up packages can handle many different clients.

- *Charts of Accounts.* Many write-up packages contain master charts of accounts that can be tailored to the needs of individual clients. Master charts of accounts save time when setting up new clients. Write-up packages are also flexible in account number formats, often allowing more characters and separators (periods, dashes, and slashes) than G/L packages.

- *Custom Data Entry.* Many packages allow users to modify the screen displays used to enter transactions. Transaction data can be modified to be consistent with the layout of client documents, which can reduce the time spent entering data.

- *Data Import.* The client's accounting system data file can be directly imported into the accountant's write-up software. Many packages allow users to import QuickBooks, Excel, and/or CSV (comma separated values) files.

- *Batch Processing.* Transactions can be entered in batches (groups) to improve the accuracy and efficiency of data entry. Batches may be checked for errors by comparing debit, credit, batch, or hash totals.

- *After-the-fact Payroll.* Many write-up packages have modules that record payroll transactions for updating the G/L and printing payroll tax forms such as W-2s, 940s, 941s, and 944s. The payroll capabilities may be standard features of the write-up program or add-on modules.

- *Report Writers.* This is where write-up packages shine. Predefined report layouts can be adapted from a master library or another client. Great flexibility is given to report headings, totaling, and account summarization. The packages often are designed to aid the accountant in producing GAAP financial statements, including cash flow statements. Most programs also provide for automatic production of the accountant's reports and notes to the financial statements.

- *Practice Management.* Some packages include time and billing modules and/or due date monitoring modules and other practice management features.

Selecting a Write-up Software Package. Because numerous accounting software packages are available, selecting the one that best meets the firm's needs can be difficult. Many accountants select a system that meets their immediate needs only to be surprised by future problems and system limitations. Therefore, the following points should be considered when choosing an accounting software package:

- *Analyze Current Operations.* The current system, whether it is useful or useless should be evaluated. Factors such as the number of current clients, the size of the practice, and the types of financial statements frequently generated (for example, special purpose framework vs. GAAP) should be considered.

- *Determine Specific Requirements.* After analyzing the firm's current operations, the specific system needs should be identified. During this process, the firm should accumulate items that are unique to their write-up practice. The list should include mandatory requirements as well as a "wish list" of items that might enhance the firm's practice.

- *Consider the Firm's Computer System.* The firm's computer environment directly impacts the type of accounting software that can be selected. The most common types of computer systems include the following:

  a. *Single Work Station.* This environment includes stand-alone personal computers located at each work station. Software programs are installed on each computer and data files are maintained on disks or the computer's hard drive.

  b. *Local Area Network (LAN).* Generally, if the firm's needs dictate a multi-user environment, local area networks (LANs) are used. LANs allow the firm's personal computers to access each other's files. Under a LAN system, a firm generally has a computer designated as the central file server that stores all client data files. To work on an accounting engagement, the user copies the data from the file server computer to his or her work station. The accounting services are then performed at the user's work station. After completing the services, the user copies the data back into the central computer file. Under this system, all files are maintained in a single location, making access very easy. However, only one person at a time may work on the files.

  c. *Web Portals.* It is becoming more and more common for firms to use web portals, where the software is maintained by the vendor and the CPA logs onto the web to access the software.

- *Reporting Capabilities.* The software's reporting capabilities are an important consideration in selecting an accounting software package. The reporting capabilities of accounting packages can vary. For instance, some accounting programs merely generate a general ledger while others produce presentation quality financial statements for single and comparative periods. In addition, some programs allow the user to modify report headings and account summarizations (for example, to print appropriate special purpose framework financial statement titles).

- *Reporting Flexibility.* Periodically, the firm may need to make reporting changes to comply with various accounting standards. The accounting software package should provide the flexibility to make those changes. It is also beneficial if the accounting software allows the accountant to include note disclosures and produce the accountant's report.

- *Ease of Use.* A significant portion of an accountant's time often is spent inputting data. Therefore, data entry should be easy and quick. When evaluating how easy a system is to use, some of the factors to consider include the following:

  a. *Easy to Learn.* A software system that is easy to learn generally requires minimal staff training. As a result, no one accountant needs to become an indispensable computer operator. If a package requires extensive training and research to operate, it generally will not promote efficiency.

  b. *Easy to Correct Errors.* The software program should allow the accountant to easily correct errors. Some systems require the user to exit one application program and reenter another application program just to correct a coding error. That process can be both time-consuming and inefficient.

c. *Easy to Set up New Clients.* New client setup should be fast and simple. The firm should look for features such as master charts of accounts and the ability to copy charts of accounts from one client to another.

d. *Single Key Stroke Options.* Some packages allow single key stroke options that allow the user to repeat the prior transaction's account number by entering a single key rather than reentering the data.

- *Importing Capabilities.* Some packages allow the client's accounting system data files to be directly imported into the accountant's write-up software.

- *Privacy and Security.* The firm must ensure the privacy of financial information. Many software systems can restrict access to financial information.

- *Cost.* If the firm has only a few write-up clients who need only generic financial statements, it might consider the general ledger software packages. However, if the firm has a large write-up practice or several clients with special reporting needs, the additional features found in higher priced write-up packages may be worth the higher cost. When evaluating price, the firm should remember that the purchase price is just one cost to consider. Operating, training, and maintenance costs should also be considered.

- *Remote Entry.* Many accounting software systems can import data from a client's computer system. Consequently, a client can input data into their computer system and transmit it to the firm via modem or computer disk.

- *Payroll.* The firm should determine if it needs after-the-fact payroll or active payroll processing. If the firm prepares its client's payroll tax returns, it should look for a package that can record payroll data (after-the-fact payroll) and prepare the appropriate payroll forms (for example, W-2s, 1099s, 940s, 941s, 944s and other forms). Some write-up clients depend on their accountants to compute their payroll and prepare payroll checks. If so, the firm should consider buying software that can handle live payroll. Because most dedicated write-up packages do not have that ability, that may mean the firm needs to buy a general ledger package or a separate payroll package.

- *Account Number Flexibility.* If clients have their own charts of accounts, the accounting software should be able to handle their account number formats.

- *Customization Capabilities.* An important question a firm needs to consider in selecting an accounting software package is whether the software can be customized. If the package can be customized, the firm will also need to consider whether the customization will meet the firm's requirements.

- *Multiple Client Capabilities.* The software should handle multiple clients and allow the accountant to easily change from one client data file to the next.

- *Link to Tax-processing Packages.* Many software packages can link to tax processing programs. Generally, these tax packages allow the firm to transfer client financial information directly into its tax return preparation software without manually reentering the data.

- *Ease of Maintenance.* Many established software manufacturers offer update/enhancement agreements, and on-line and toll-free telephone support agreements at additional cost. It may make sense to purchase both types of those agreements if staff members are not familiar with the software or the firm wants to keep current with the most recent release of the software.

- *Licensing.* Software is usually not sold, it is licensed. Therefore, a firm should review the licensing agreements associated with various software packages. Purchasing a license generally allows the user to install the software on a specific number of computers. If a firm needs its staff members to work on more than one computer, it should either buy multiple copies, buy and install a local area network (LAN), or buy a site license. (The last option is normally only cost-effective when many copies are needed.)

- *Vendor Reliability.* It is important to be sure the vendor is reliable, has sufficient resources to satisfy the firm's requirements, and will be available when needed.

An important aspect in choosing accounting software is knowing what software packages are available. Often there are many choices within each category of accounting software programs (low-cost, mid-range, or high-end). The following are suggested procedures for gathering evidence about specific software packages:

- *Review Product Literature.* Product literature can provide valuable information about a particular software package's specialized capabilities. When a package adequately meets a specific need, that feature will often be touted in product literature. Of course, product literature contains purely promotional material and will always be biased about the product's capabilities. Furthermore, product literature rarely points out a product's weaknesses.

  The firm may obtain product literature by contacting the software developer directly, or, if the product is sold locally, by contacting the local dealer. When contacting a software developer or dealer, the firm should ask about the types of available literature. Some vendors may only send glossy sales promotion literature. Others may send detailed specifications of the product's capabilities and limitations and, possibly, a demonstration disk for review. Vendors also may send either an information packet that includes copies of magazine software reviews or ask permission for a salesperson to call and show their products.

- *Search Online Information Services.* Online information services offer many features including access to various information databases. The databases contain vast amounts of reference data in the form of text, graphics, and programs. The information is usually in specific databases grouped by subject matter, and many of the databases contain information pertaining to computer software packages. By reviewing that information, the firm has up-to-date information about various software packages and can review multiple packages quickly and easily. There are also many commercial services that provide access to database services. *PPC's Guide to Write-Up Services* provides additional information on various online commercial services.

- *Contact the Software Developer Support Line.* The software developer support line can be an excellent source of information about whether a particular package meets the firm's needs. This contact also can reveal the quality of the developer's support line.

- *Contact a Local Dealer or Sales Representative.* A local dealer or sales representative usually can provide information about prices, availability of modules, current versions, and upgrades. Some dealers who are also installers can provide valuable information about a particular package's capabilities. On the other hand, some dealers do not install the software and will be unable to provide insights about its detailed capabilities. As with the product literature, dealers' answers may be biased toward their own software products.

- *Contact Other Current Users.* When contacting software developers or local dealers, the firm should request references from other firms who use the software. The firm may want to contact the references and ask questions similar to the following.

  a. How well is the software working?

  b. What is the quality of vendor support?

  c. Do you have any problems with the system?

  d. Would you recommend the system?

- *Read Accounting Software Reviews.* Generally, there are two types of reviews—single product reviews and comparison reviews. Single product reviews are usually written by someone who has experience with the reviewed software product. The writer's insight may offer an in-depth understanding of the software, but also may express a favorable bias toward the software, especially if the author is a representative of the software company. On the other hand, comparison reviews generally compare many accounting software packages. The reviews are usually prepared by individuals who have worked with many products and can identify the key differences. Although the authors probably do not have in-depth knowledge of all the products reviewed, their comparative reviews are usually less biased than single product reviews. Furthermore, comparative reviews typically have tables comparing features. *PPC's Guide to Write-Up Services* contains a list of accounting software review sources.

INDEPENDENCE ISSUES

Independence is an important issue for many small practitioners because the only type of report a CPA can issue on financial statements of a nonpublic entity when he or she is not independent is a compilation report. However, independence is much easier to define than to apply. An infinite variety of situations can occur that raise questions regarding independence issues but are not necessarily independence problems. Therefore, it is important for CPAs to understand the various rules and regulations that govern independence. The following paragraphs discuss the authoritative literature relating to independence and provide some examples of client services or situations that might impair an accountant's independence.

Authoritative Literature Relating to Independence

The primary rules governing independence are found in the AICPA *Code of Professional Conduct* (Code). CPAs should read ET 1.200 of the Code for guidance concerning independence.

Independence requirements also can be found in the SSARS, auditing standards, and statements on standards for attestation engagements. While the authoritative literature governing these various types of engagements contains a great deal of discussion about the concepts of independence, identifying independence problems, and about resolving nonindependence situations, the basic concept of independence is the same regardless of the level of service or the type of engagement. Basically, accountants are independent if they are free from obligation to or interest in their clients.

In addition, QC 10 imposes independence requirements on accountants, including requiring the firm, at least annually, to obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent. The representations should indicate whether the employee is complying with all of the requirements of ET 1.200 of the Code, as well as the rules of state boards of accountancy and applicable regulatory agencies. Additional guidance regarding QC 10 can be found in *PPC's Guide to Quality Control—Compilation and Review*.

Conceptual Framework for Independence. The Professional Ethics Executive Committee's (PEEC) Conceptual Framework for AICPA Independence Standards (ET 1.210.010 of the Code) describes the risk-based approach used by PEEC to determine whether a member's relationship with a client poses an unacceptable risk to the member's independence.

<u>No Independence Interpretations or Rulings.</u> In situations where there are no independence interpretations or rulings that address an accountant's particular independence circumstance, ET 1.210.010.01 of the Code requires the accountant to evaluate whether his or her particular independence situation would lead a reasonable person who is aware of all of the facts to conclude that the accountant is not independent. When making that determination, accountants should refer to the risk-based approach described in the Conceptual Framework for AICPA Independence Standards.

<u>Required Documentation.</u> If the threats to independence are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level. In instances where threats to independence are not at an acceptable level, thereby requiring safeguards, the following should be documented:

- The threats identified.
- The safeguards applied to eliminate the threats or reduce them to an acceptable level.

<u>Unacceptable Risk.</u> The Introduction to the Conceptual Framework for AICPA Independence Standards indicates that under a risk-based approach to analyzing independence, a member's relationship with a client is evaluated to determine whether it poses an unacceptable risk to the member's independence. Risk is unacceptable if the relationship would compromise (or would be perceived as compromising by an informed third party having knowledge of all relevant information) the member's professional judgment when rendering an attest service to the client.

Threats. Threats to independence are circumstances that could impair independence. Many different circumstances (or combinations of circumstances) can create threats to independence. Some examples include the following:

- *Self-review Threat.* Reviewing your own nonattest work, or that of your team, as part of the attest engagement.

- *Advocacy Threat.* Actions that promote an attest client's interests or position, such as representing a client in tax court.

- *Adverse Interest Threat.* Actions or interests between the accountant and the client that are in opposition, such as a threat of litigation by either party.

- *Familiarity Threat.* Accountants who have close or longstanding relationships with attest clients.

- *Undue Influence Threat.* Attempts by an attest client's management to exercise influence over the accountant, such as pressure to reduce audit procedures for the purpose of reducing audit fees.

- *Financial Self-interest Threat.* Potential benefit to an accountant from a financial relationship with an attest client, such as excessive reliance on revenue from a single attest client.

- *Management Participation Threat.* Performing management functions on behalf of an attest client, such as making hiring decisions.

Safeguards. Safeguards are controls that mitigate or eliminate threats to independence. To be effective, safeguards must eliminate the threat or reduce to an acceptable level the threat's potential to impair independence. There are three broad categories of safeguards:

- *Safeguards Created by the Profession, Legislation,* or *Regulation.* Examples include continuing education requirements on independence and ethics, and external review of a firm's quality control system.

- *Safeguards Implemented by the Attest Client.* Examples include a tone at the top that emphasizes the attest client's commitment to fair financial reporting, and policies and procedures that are designed to achieve fair financial reporting.

- *Safeguards Implemented by the Firm.* Examples include rotation of senior personnel who are part of the attest engagement team, and the involvement of another firm to perform part of an audit.

Impairment of Independence by Unpaid Fees

An accountant's independence can be impaired by unpaid fees. Specifically, ET 1.230.010.02.–03 of the Code states that an accountant's independence is considered impaired if fees (billed or unbilled) for professional services rendered more than one year prior to the date of the accountant's report remain unpaid when the current year's report is released. (While ET 1.230.010.02–.03 does not indicate that the unpaid fee must be of a certain amount before it impairs independence, it seems likely that clearly inconsequential amounts would not impair independence.) Generally, the engagement partner assigned to each client is aware of not only the status of uncollected fees, but also unbilled fees applicable to that client. Accordingly, it is a best practice to give the engagement partner (or the in-charge accountant under the engagement partner's supervision) the primary responsibility for determining if there are unpaid fees that would impair the firm's independence. That partner should determine that all prior year's fees (including tax and consulting engagement fees) are collected before the current year's report is issued.

Does Providing Accounting/Write-up Services Impair a CPA's Independence?

For a small business engagement, a frequent concern about meeting independence requirements is the effect of providing accounting assistance to the client. An accountant may be asked to provide accounting services to clients who are too small to employ an adequate accounting staff and concerns may arise that the accountant's independence has been impaired in these circumstances. In addition, for many small businesses, the accountant serves as a primary business consultant and may unknowingly be providing services as part of a compilation or review engagement that impair his or her independence. The following paragraphs discuss the effects of accounting/write-up services on independence and specifically address ET 1.295 of the Code.

Nonattest Services. ET 0.400.04 of the Code defines an *attest engagement* as an engagement that requires independence. Audits, examinations, agreed-upon procedures engagements, reviews, and compilations are, therefore, attest engagements. With the exception of compilations, attest engagements cannot be performed if the accountant's independence is impaired; compilations can be performed provided the accountant's report discloses the lack of independence. ET 1.295 of the Code describes the requirements that must be met in order for the performance of nonattest services for an attest client to *not* impair independence:

- *The Client Agrees to Perform Certain Functions.* The accountant should be sure that the client is in a position to make an informed judgment on the results of the nonattest services and that the client understands its responsibilities to—

  a. Assume all management responsibilities.

  b. Oversee the service by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, or experience.

  c. Evaluate the adequacy and results of the services performed.

  d. Accept responsibility for the results of the services.

  The accountant should also assess and be satisfied that the designated individual who will oversee the services sufficiently understands the services to be performed by the accountant to ensure oversight. Also, the accountant ought to assess the suitability of their skills, knowledge, and/or experience. In cases where the client is unable or unwilling to assume all of these responsibilities, or is unwilling to carry out such responsibilities, the accountant's performance of the nonattest services would impair independence.

- *The Member Should Not Assume Management Responsibilities.* Independence is considered to be impaired if an accountant (or his or her firm) assumes management responsibilities. However, the accountant may assist management in those responsibilities.

- *The Understanding Between the Member and the Client Should be Documented in Writing.* To help prevent any type of misunderstanding with the client, ET 1.295.040.01 states that *before* performing the nonattest services, the accountant should document in writing his or her understanding with the client regarding the following—

  a. Objectives of the engagement (i.e., the nonattest services).

  b. Services to be performed.

  c. Client's acceptance of its responsibilities.

  d. Accountant's responsibilities.

  e. Any limitations of the engagement.

  There are no specifications on how the written understanding is to be documented, so the accountant has flexibility. For example, the understanding might be documented in a separate engagement letter, in the workpapers, in an internal memo, or in the engagement letter obtained in conjunction with an attest engagement. It seems common in many small business engagements for the accountant to also provide nonattest services, such as tax return preparation or bookkeeping services.

Certain activities performed as part of a nonattest service are considered to be management responsibilities, and therefore impair independence regardless of whether the accountant complies with the other requirements of ET 1.295 of the Code. In addition, if an accountant assumes a management responsibility for an attest client, the management participation threat created would be so significant that no safeguards could reduce the threat to an acceptable level. The Interpretation lists common nonattest service activities and notes whether they are or are not considered to impair independence. ET 1.295.030.02 specifically states that performance of the following activities would be considered a management responsibility, and would therefore impair an accountant's independence (that is, they would preclude the accountant from being independent):

- Setting policies or strategic direction for the client.
- Directing or accepting responsibility for the actions of the client's employees, except to the extent permitted when using internal auditors.
- Exercising authority on behalf of a client, such as authorizing, executing, or consummating a transaction, or having the authority to do so.
- Preparing source documents, in electronic or other form, that evidence the occurrence of a transaction.
- Having custody of client assets.
- Deciding which of the accountant's or other third parties' recommendations should be implemented or prioritized.
- Reporting to those in charge of governance on behalf of management.
- Serving as a client's stock transfer or escrow agent, registrar, or general counsel.
- Accepting responsibility for the management of a client's project.
- Accepting responsibility for the preparation and fair presentation of the client's financial statements in accordance with the applicable financial reporting framework.
- Accepting responsibility for designing, implementing, or maintaining internal controls.
- Performing ongoing evaluations of the client's internal control as part of its monitoring activities.

ET 1.295.160 of the Code also addresses tax compliance services. Preparing a tax return and transmitting the tax return and related payment, either electronically or in paper form, to a taxing authority does not impair independence as long as the accountant does not have custody or control of the client's funds and the individual overseeing the tax services (a) reviews and approves the return and payment and (b) signs the return prior to transmittal, if required for the filing. Signing and filing a tax return impairs independence unless the accountant has legal authority to do so and—

- the taxing authority has prescribed procedures, allowing the taxpayer to permit the accountant to sign and file a return on their behalf, that meet the standards for electronic return originators and officers outlined in IRS Form 8879, or
- an individual in client management who is authorized to sign and file the tax return provides the accountant with a signed statement that indicates—
  - The return being filed.
  - That the individual is authorized to sign and file the return.
  - That the individual has reviewed the return, including accompanying schedules, and it is true, correct, and complete to the best of their knowledge and belief.
  - That the individual authorizes the accountant to sign and file the return on behalf of the client.

Also, the accountant's representation of the client in an administrative proceeding before a taxing authority does not impair independence providing that the accountant obtains the client's agreement prior to committing the client to a specific resolution with the taxing authority. Independence is impaired if the accountant represents the client in court or in a public hearing to resolve a tax dispute.

In addition, under ET 1.295.110 of the Code, certain appraisal, valuation, or actuarial services are considered to impair independence. Performing appraisal, valuation, or actuarial services impairs independence if the results are material to the financial statements and the service involves significant subjectivity. For example, a material asset appraisal or business valuation generally involves significant subjectivity, and therefore would impair independence if performed for financial statement purposes. However, an actuarial valuation of a client's pension liabilities ordinarily does not require significant subjectivity and, therefore, would not impair independence even if the amount was material.

Under ET 1.295.140 of the Code, certain types of forensic accounting services may impair independence. Independence is impaired if an accountant conditionally or unconditionally agrees to provide expert witness testimony for a client. However, under certain defined conditions, independence is not impaired if the accountant provides expert witness testimony for a large group of plaintiffs or defendants that includes the accountant's client. If the accountant provides litigation services where he or she is a trier of fact, special master, court-appointed expert, or arbitrator in a matter involving a client, independence is impaired.

In some cases, the accountant may assist with the client's internal audit function. ET 1.295.150 of the Code also addresses the impact of those services on the accountant's independence. Performance of internal audit assistance services does not impair the accountant's independence as long as the accountant is not an employee of the client or does not act in the capacity of management (for example, determining the scope, risk, and frequency of internal audit activities). The accountant should be satisfied that the client (a) understands its responsibility for internal controls (including ongoing monitoring) and (b) understands its responsibility for directing the internal audit function. The general requirements for the performance of nonattest services discussed above (such as documenting the understanding with the client) also must be met. With respect to providing assistance with the internal audit function, the accountant should be satisfied that those in charge of governance are fully informed of the engagement.

Although performing an individual nonattest service might not impair independence, the cumulative effect of multiple nonattest services can increase the significance of threats to independence. As discussed in ET 1.295.020 of the Code, before agreeing to perform the services, the member should evaluate whether the aggregate effect of performing multiple nonattest services results in a significant threat to independence that cannot be reduced to an acceptable level by the application of safeguards. If there are no safeguards that eliminate the threat or reduce it to an acceptable level, the member's independence would be impaired. It is not necessary to consider threats that might be created when other network firms within the member's firm's network provide nonattest services. Whether the performance of multiple nonattest services for the client creates a threat to independence should be documented.

Should Proposing Journal Entries and Preparing Financial Statements in Connection with a Compilation or Review Be Viewed as Bookkeeping and, Therefore, Nonattest Services? ET 1.295.120.01 of the Code includes bookkeeping as an example of a nonattest service. Rather than define bookkeeping, ET 1.295.120.02 provides several examples of services that would be considered bookkeeping. Two of those examples are (a) proposing standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client and (b) preparing financial statements based on information in the trial balance. Practice questions have arisen as to whether those examples mean that proposing journal entries and preparing financial statements in connection with a compilation or review should be viewed as bookkeeping and, therefore, nonattest services. ET 1.295.010.06 of the Code considers activities such as financial statement preparation, cash to accrual conversions, and reconciliations performed by the member as nonattest services, even if the services are performed as part of the attest engagement. Nonattest services performed for an attest client will not impair a firm's independence as long as the safeguard requirements of ET 1.295 are met.

Additional Questions in Applying ET 1.295 of the AICPA *Code of Professional Conduct*. The following are questions that are likely to arise as accountants apply the requirements of ET 1.295. The responses reflect the views expressed by this course on such matters based on the requirements of ET 1.295.

a. *Impact on Compilation and Review Services.*

- *Question*—How does ET 1.295 impact compilation and review services?

- *Response*—If the accountant performs nonattest services for a compilation or review client, independence will be impaired if *any* of the following occurs:

  (1) The accountant assumes management responsibilities.

  (2) The client is unwilling or unable to: assume *all* management responsibilities; oversee the service by designating an individual, preferably within senior management, who possesses suitable skill, knowledge and/or experience; and evaluating the adequacy and results of, and accepting responsibility for, the services provided.

  (3) The accountant does not establish the understanding with the client regarding: the objectives of the engagement, the services to be performed, the client's acceptance of its responsibilities, the accountant's responsibilities, and any limitations of the nonattest engagement.

  If independence is impaired, the accountant may still issue a compilation report as long as the report is modified to indicate the lack of independence. The following sentence should be added to the report to indicate the lack of independence. The reason(s) for the lack of independence may also be added, if desired.

  > We are not independent with respect to the entity. If the accountant chooses to disclose the reason(s) for the lack of independence in the report, the accountant should ensure that all reasons are included in the description. The following are some examples of descriptions the accountant may use:

  (4) We are not independent with respect to the entity as of and for the year ended December 3, 20XX, because a member of the engagement team had a direct financial interest in the entity.

  (5) We are not independent with respect to the entity as of and for the year ended December 31, 20XX, because an immediate family member of one of the members of the engagement team was employed by the entity.

  (6) We are not independent with respect to the entity as of and for the year ended December 31, 20XX, because we performed certain accounting services that impaired our independence.

b. *Providing Routine Advice to Clients.*

- *Question*—If a client calls the accountant and asks a technical question, would this be considered a nonattest service for which ET 1.295 would apply?

- *Response*—No, routine activities performed by the accountant, such as providing advice and responding to clients' technical questions as part of the normal client-accountant relationship, are not considered nonattest services for which ET 1.295 would apply.

  However, the accountant should exercise judgment in determining whether his or her involvement is so extensive (i.e., due to the number or frequency of such routine activities) that it constitutes performing a separate service that would be subject to the ET 1.295 requirements.

c. *Documentation Requirements*

- *Question*—Does the documentation requirement apply to all client engagements, and does the documentation have to be in the form of an engagement letter?

- *Response*—No, the documentation requirement only applies to nonattest services (for example, bookkeeping, tax, financial statement preparation, or consulting services) performed by the accountant for an attest client when the accountant wishes to remain independent.

  The accountant is required to document his or her understanding regarding the nonattest services with the attest client, but no specific form of documentation is required. Consequently, the required nonattest services understanding might be documented in an attest engagement letter, in a separate nonattest services engagement letter, in a separate workpaper or in an internal memo.

d. *Inadvertent Noncompliance.*

- *Question*—What if the accountant inadvertently fails to comply with the requirement to document in writing the accountant's understanding with the client?

- *Response*—A failure to document the understanding with the client is not considered to impair a member's independence provided such understanding has been established. Rather, failure to document this understanding is considered a violation of the *Compliance With Standards Rule* of the Code (ET 1.310).

  In addition, the peer review checklist says that if the accountant is not in compliance with the documentation requirements, then the accountant must provide convincing evidence in order to enable the reviewer to conclude that an independence impairment does not exist.

e. *Independence Rules of Other Regulatory Bodies.*

- *Question*—If the accountant performs attest services for his or her client and the work is subject to oversight by other regulatory bodies (e.g., Government Accountability Office, Department of Labor, and Securities and Exchange Commission), how does the "Nonattest Services" subtopic (ET 1.295) apply?

- *Response*—The requirements of the "Nonattest Services" subtopic must be met, along with any independence rules of the applicable regulatory body that are more restrictive than the requirements of the Interpretation. Failure to comply with independence rules of the regulatory body relating to nonattest services would constitute a violation of the Independence Rule (ET 1.200.001).

f. *Documentation of Assessment of Suitable Skills, Knowledge, and Experience (SKE).*

- *Question*—Does the accountant have to document satisfaction of the SKE of the individual overseeing the nonattest services?

- *Response*—No. However, in peer review, firms now have to answer questions in regards to independence and performing nonattest services as part of the engagement questionnaire completed for each engagement selected for review. One of those questions asks the firm to describe their assessment and factors leading to their satisfaction that the client personnel overseeing the nonattest services had sufficient SKE to oversee the nonattest services.

g. *Third-party Outsourcing.*

- *Question*—Can the client contract with a third party to oversee the accountant's performance of the nonattest services?

- *Response*—Yes. The attest client can outsource the nonattest services oversight functions to a third party. That third party would then serve as the individual designated by management to oversee the nonattest services.

h. *Client Approval of Proposed Journal Entries.*

- *Question*—Is the accountant required to document the attest client's review and approval of accountant proposed journal entries?

- *Response*—No. However, the accountant may choose to document the name of the client individual who reviewed and approved the journal entries and the date of his or her review in order to provide evidence that the accountant did not assume management responsibility of reviewing and approving the entries.

i. *Assessing Whether an Individual Possesses Suitable Skill, Knowledge, or Experience.*

- *Question*—How does an accountant assess a client's designated employee possesses suitable skill, knowledge, or experience as required by the Interpretation?

- *Response*—It is not intended that the client's employee possess a level of technical expertise equal to the accountant's. The client employee need only understand the nonattest services enough to be able to provide general direction for the services; understand the key issues the accountant identifies; make any required management decisions; and evaluate the adequacy of, and accept responsibility for, the results of the accountant's work. This may mean the accountant will need to educate his or her client in order to allow them to assume these responsibilities. For example, if the accountant performs routine bookkeeping services for an attest client, he or she could ensure compliance with the requirements of the Interpretation by reviewing the proposed journal entries with the client and explaining in general terms how each entry affects the financial statements. The client should then be in a position to approve the journal entries and accept responsibility for the financial statements.

j. *Nonattest Services Performed before the Client Becomes an Attest Client*

- *Question*—The accountant accepts a compilation or review engagement for a client for whom he or she has previously provided only bookkeeping services. Prior to accepting the attest engagement, the practitioner does not have a written understanding with the client under ET 1.295 of the Code. Has the practitioner violated the documentation requirement of the "Nonattest Services" subtopic? Is the practitioner's independence impaired?

- *Response*—The ET 1.295 documentation requirement does not apply to nonattest services performed before the client becomes an attest client. The accountant would be permitted to prepare the required documentation upon acceptance of the compilation or review engagement, provided the accountant is able to demonstrate his or her compliance with the other general requirements during the period covered by the financial statements, including the requirement to establish an understanding with the client.

  The practitioner's independence would not be impaired when the practitioner performed nonattest services that would have impaired independence during the period covered by the financial statements, provided that the nonattest services were provided prior to accepting the attest engagement, the nonattest services were for a period prior to the financial statement period, and the financial statements for the period to which the nonattest services relate were reviewed or audited by another firm.

  As a practical matter, practitioners who are initially engaged to only provide nonattest services but expect to subsequently be engaged to also provide attest services should consider structuring the engagement so that performance of the nonattest services will not impair independence for the attest services.

Illustrative Examples. Independence is much easier to define than to apply. An infinite variety of situations can occur that raise questions about independence but are not necessarily impairment problems. The following paragraphs provide several scenarios relating to accounting services in which accountants' independence might be impaired. Also included with each scenario is commentary specific to this course (considering the guidance in ET 1.295 of the Code and related nonauthoritative guidance) about whether or not the services are permitted under ET 1.295 (that is, whether or not the services impair the accountant's independence).

a. **Scenario:** A CPA accepts the responsibility of signing or cosigning a client's checks in emergency situations.

   Is Independence Impaired? Yes, independence of the CPA would be considered to be impaired since such activities are considered management responsibilities. Having the authorization to sign or cosign checks on a client's bank account, even if such activity is never performed, impairs independence.

b. **Scenario:** A CPA performs payroll services for a client including preparing payroll tax forms and returns (for example, Form 941, Form W-2, etc.) and preparing semimonthly payroll checks. The CPA also cosigns each payroll check on behalf of an officer of the client.

   Is Independence Impaired? Yes, independence of the CPA would be considered to be impaired because having the authorization to sign or cosign checks on a client's bank account is a management responsibility. Preparation of payroll tax returns also impairs independence unless the requirements outlined earlier in this discussion are met. In addition, making electronic payroll tax payments does not impair independence provided the payments are made in accordance with U.S. Treasury Department or comparable guidelines and the client has made arrangements for its financial institution to limit such payments to the named payee.

c. **Scenario:** When performing monthly accounting services for a client, the CPA codes the check stubs (that is, determines the general ledger accounts to which the disbursements should be recorded and writes the appropriate account numbers on each check stub) based on the description included by the client on the check stubs.

   Is Independence Impaired? No, independence is not impaired. Normally, coding check stubs will not impair the accountant's independence as long as the client provides sufficient detail to clearly identify the nature of each transaction. Note that, in some cases, the accountant can determine the nature of a transaction based on who the check has been issued to (for example, the electric company, office supply company, etc.). However, the accountant should be careful not to assume the role of management, thereby losing independence with respect to the client.

d. **Scenario:** A CPA records journal entries in the client's accounting system.

   Is Independence Impaired? No, the accountant's independence would not be impaired provided that the client understands the nature and impact of the journal entries. For example, the accountant could provide the client with a printout of proposed journal entries accompanied by clear explanations, ask the client to review the printout, and then ask whether the client has any questions about the entries. Although not required, some accountants obtain the client's written approval of the proposed journal entries by, for example, signing or initialing the journal entries or on a separate journal entry approval form. If a representation letter is obtained (as in a review), such language might also be included in the representation letter.

e. **Scenario:** A CPA installs pre-packaged accounting software, such as QuickBooks®, for his or her client and sets up the chart of accounts and financial statement format defaults.

   Is Independence Impaired? No, the CPA's independence is not impaired. In its *Background and Basis for Conclusions*, the Professional Ethics Executive Committee states that independence is not considered impaired, as this type of service does not constitute "designing" a system, provided the CPA does not create or change the source code(s) underlying the pre-packaged software.

The AICPA has an Ethics Hotline where members of the AICPA's Professional Ethics Team answer questions about independence and other behavioral issues. The toll-free number for the Ethics Hotline is (888) 777-7077.

CONSULTATIONS AND DIFFERENCES OF OPINION

When performing compilation and review engagements, accountants may need to consult with someone not involved in the engagement on complex technical or ethical issues. However, accountants often have certain questions and concerns regarding that consultation. For example, "Are accountants *required* to resolve complex technical questions through consultation when performing compilation and review engagements? If consultation is used, when and what should the workpapers document?" To help practitioners sort through some of these concerns, the following paragraphs address some of the issues regarding consultation in compilation and review engagements.

Do the Standards Require Accountants Performing Compilation and Review Engagements to Resolve Complex Technical Issues through Consultation?

A good starting point for understanding whether the standards require consultation is a quick review of the authoritative literature as it relates to consultation. The SSARS require the accountant to possess or obtain a level of knowledge of the accounting principles and practices of the client's industry. Such knowledge may be obtained, among other ways, by consulting in-firm or outside firm individuals. In addition, QC 10.37 indicates that CPA firms should establish quality control policies and procedures over consultation to provide the firm with reasonable assurance that—

- Consultation takes place when appropriate (such as when dealing with complex, unusual, unfamiliar, difficult, or contentious issues).
- Sufficient and appropriate resources are available to enable appropriate consultation to take place.
- The nature and scope of such consultations are documented and are understood by both those seeking consultation and the individual consulted.
- The consultation conclusions reached are documented and implemented.

Finally, ET 1.300.010.03 of the Code recognizes that consultation with others may be necessary during the performance of professional services. Based on this guidance, it seems logical that, in the appropriate circumstances, the standards indicate that accountants may need to resolve complex technical issues through consultation when performing compilation and review engagements.

When to Document Consultation

The following suggestions may help practitioners determine when to document consultations:

a. *Questions, Discussions, and Research Matters Regarding Unusual, Controversial, or Complex Accounting, Procedural, or Reporting Issues that Are Material in Nature Generally Should Be Documented.* Examples include—

  - An engagement in which a qualified or nonstandard report is likely.
  - An engagement involving material litigation.
  - First time application of new or complex technical pronouncements.
  - Industries with special accounting, auditing, or reporting requirements.
  - Emerging practice problems.
  - Choices among alternative generally accepted accounting principles upon initial adoption or when an accounting change is made.
  - Reissuance of a report, consideration of omitted procedures after a report has been issued, or subsequent discovery of facts that existed at the time a report was issued.
  - Filing requirements of regulatory agencies.

(Some firms specify situations that require consultation and documentation in the firm's quality control policies and procedures. In those situations, the firm should ensure that all personnel are aware of, and recognize, situations where firm policy requires consultation and documentation.)

b. *Questions, Discussions, and Research Matters of a General Nature or of Minor Technical Importance Generally Do Not Require Documentation.* The decision of whether a question is of a general nature or of minor technical importance versus one that is unusual or controversial and material should be made by the engagement partner or under his or her supervision. Once the determination is made that the issue is unusual or controversial and material, the firm should follow consistent documentation procedures.

In-firm Consultation versus Outside-firm Consultation

Many practitioners tend to think of consultation only in terms of consultation with experts outside their firms. However, consultation includes both consultation within and outside the firm.

In-firm Consultation. Consultation within the firm includes making use of the technical reference materials in the firm's library as well as seeking the personal expertise of other individuals within the firm. In fact, some firms designate a particular person to become an expert in unusually complex areas, such as leases or pension plans. The extent of specialization varies with firm size and individual firm preference. Naturally, the smaller a firm is, the less likely the firm has specialists available for consultation.

At a minimum, for in-firm consultation, it is a best practice for the firm to include the following in its professional library (or have ready access to):

a. *AICPA Pronouncements.* The AICPA, through its senior and technical committees and task forces, issues pronouncements that govern a wide range of topics including accounting, auditing, compilation, review, and other professional services; professional ethics; and quality control. Its pronouncements can be found in the following resources.

   (1) *AICPA Professional Standards.* This resource contains all of the currently effective pronouncements on professional standards issued by the AICPA, the International Federation of Accountants, and the International Accounting Standards Board. Consequently, it includes Auditing Standards, Statements on Standards for Attestation Engagements, Statements on Standards for Accounting and Review Services, and the Interpretations related to those Statements. It also includes the AICPA *Code of Professional Conduct*, AICPA Bylaws, Statement on Standards for Consulting Services, Statements on Quality Control Standards, Standards for Performing and Reporting on Peer Reviews and related Interpretations, Statements on Standards for Tax Services and related Interpretations, Statements on Standards in Personal Financial Planning Services, and Statement on Standards for CPE Programs and related Policies and Forms. Finally, the resource includes Statements of International Accounting Standards, Statements of International Standards on Auditing, and International Statements on Auditing.

   (2) *Industry Audit and Accounting Guides.* These guides include recommendations for applying GAAP to financial statements of entities in specific industries and on applying certain audit methods to all financial statement audits.

   (3) *Technical Questions and Answers.* This resource includes selected Technical Information Service Questions and Answers, Accounting Statements of Position, Audit and Attest Statements of Position, Practice Bulletins, Issues Papers of the Accounting Standards Division, and Practice Alerts.

   (4) *AICPA Risk Alerts.* Although most small firms do not need all of the alerts, each firm needs the alerts that are applicable to its practice.

   The preceding publications are available in bound or loose-leaf format and can be ordered by calling the AICPA Order Department at (888) 777-7077 or online at **www.aicpastore.com**. They are also available via online through Thomson Reuters by calling (800) 431-9025 or at the website **tax.thomsonreuters.com**, in conjunction with ownership of Thomson Reuters *Guides*.

b. *FASB Codification.* The *FASB Accounting Standards Codification* (FASB Codification) is the single source of authoritative U.S. generally accepted accounting principles (GAAP) to be applied by nongovernmental entities. The FASB Codification is available in two online versions (professional or basic). The basic online version is available at no charge and provides browsing by topic, basic print functionality, and utility to identify the location of the original standards. The professional online version, while not free, provides more extensive functionality and features. The FASB currently continues to provide bound volumes of certain pre-FASB Codification products, such as Original Pronouncements, Interpretations, and Technical Bulletins. The pre-FASB Codification products do not include authoritative guidance issued since the FASB codification became effective.

   The FASB Codification on Checkpoint is available as an add-on with a subscription to any PPC product on Checkpoint. The FASB Codification on Checkpoint provides enhanced functionality and advanced navigation related to the FASB Codification material and also accesses the complete library of prior statements, standards, and other supporting material. Contact Thomson Reuters at (800) 431-9025 or at the website **tax.thomsonreuters.com**.

   All of the FASB publications can be ordered from the FASB by calling their Order Department at (800) 748-0659 or via their website, **www.fasb.org**. Many of the pre-FASB Codification pronouncements are still available at no charge as originally issued on the FASB's website at **www.fasb.org**.

c. *Pronouncements of the Governmental Accounting Standards Board (GASB).* Similar to the FASB, the GASB is the primary standards-setting body for governmental accounting. Its pronouncements include Statements of the Governmental Accounting Standards Board, GASB Interpretations, GASB Technical Bulletins, consensus positions of the GASB Emerging Issues Task Force, and implementation guides prepared by the GASB's staff. Further information about GASB publications can be obtained by calling the GASB Order Department at (800) 748-0659 or online at **www.gasb.org**.

d. *Accounting and Auditing Manuals.* There are several sources that provide accounting and auditing manuals for local firms. Obviously, this course recommends Thomson Reuters' PPC brand of manuals. They are interfaced with *PPC's Guide to Compilation and Review Engagements*, updated annually, and generally have been peer reviewed. For more information and a list of all accounting and auditing manuals available, visit Thomson Reuters' website at **tax.thomsonreuters.com** or call (800) 431-9025.

e. *Industry and Specialty Reference Sources.* Include in the firm library reference manuals that provide specialized guidance relating to the types of industries served by the firm.

Outside Firm Consultation. On particularly complex matters, outside consultation may be advisable. Some firms prepare a list of outside specialists that should normally be consulted when an accounting, SSARS, or tax issue is encountered. That party may be the technical arm of an association of firms, a specific CPA, or a tax lawyer that has a consulting relationship with the firm. In addition, the AICPA has a technical information service that answers inquiries on complex accounting, auditing, and SSARS issues. The toll-free number for this service is (888) 777-7077. The AICPA also has an Ethics hotline where members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other issues related to the application of the AICPA *Code of Professional Conduct*. The toll-free number for the Ethics Hotline is (888) 777-7077.

Differences of Opinion

QC 10 has requirements for dealing with and resolving differences of opinion as part of the engagement performance element.

Occasionally, differences of opinion concerning accounting issues may arise among—

- Firm personnel within the engagement team.
- The firm and individuals consulted.
- The engagement partner and the engagement quality control reviewer.

QC 10.46 states that firms should establish policies and procedures for dealing with and resolving differences of opinion. Those policies and procedures should require that (a) conclusions reached be documented and implemented, and (b) the report not be released until the difference of opinion is resolved.

If procedures are effective, they will encourage identification of differences of opinion at an early stage. They will also provide clear guidelines about the successive steps to be taken thereafter. In addition, procedures should require documentation regarding the resolution of the differences and the implementation of the conclusions reached. Procedures to resolve such differences may include consulting with another practitioner, firm, or professional or regulatory body.

Conclusions reached when dealing with differences of opinion should be documented. Specific guidance regarding this documentation is not provided in QC 10. Care should be exercised in establishing policies and procedures for documenting differences of opinion. If the firm establishes documentation procedures that are too stringent, staff personnel may be discouraged from initiating general discussions of technical questions or issues for fear that these exchanges of ideas demand too much documentation time and effort.

It is a best practice to document matters of a material nature, but not to document matters of a general nature or of minor technical importance. The decision of whether a question is of a general nature or of minor technical importance versus one that is material should be made by the engagement partner. Once the determination has been made that the issue is material, the firm should follow consistent documentation procedures.

Withdrawing from an Engagement or Ending a Client Relationship

When drafting policies and procedures for withdrawal from an engagement or a client relationship, QC 10.A16 explains that such policies and procedures may address issues that include the following:

- Discussing with the appropriate level of client management and those charged with governance appropriate actions that the firm might take.
- When the firm's decision is to withdraw, discussing that decision and the reasons for it with the appropriate level of client management and those charged with governance.
- Considering whether there are professional, regulatory, or legal requirements to (a) remain associated with the client and the engagement, or (b) report the withdrawal together with the reasons for it to regulatory authorities.
- Documenting significant matters, consultations, conclusions, and the basis for the conclusions.

SSARS literature requires an accountant to withdraw from a compilation or review engagement in the following circumstances:

- The accountant becomes aware that information supplied by the client is incorrect, incomplete, or otherwise unsatisfactory, and the client refuses to provide additional or revised information (AR-C 80.16 and AR-C 90.A47). This includes not providing sufficient information to support the fact that financial statements are not materially misstated due to fraud, or that the entity is in compliance with laws and regulations (AR-C 90.51), in those instances where the accountant becomes aware that fraud may exist, or suspects noncompliance with laws and regulations.
- In a review, the accountant believes the written representations are unreliable or the client refuses to provide a representation letter, and the accountant decides (as would ordinarily be the case) that it is not appropriate to issue a compilation report (AR-C 90.37).
- A modification of the standard report will not adequately indicate the deficiencies in the financial statements taken as a whole (AR-C 80.32 and AR-C 90.59).

Documenting a Withdrawal. Any serious consideration to withdraw from an engagement would generally prompt significant discussion and major consultation among the partners of the firm. As discussed earlier in this lesson, QC 10 requires that major consultations be documented and filed in the engagement workpapers. Although the QC standard only suggests that policies and procedures for withdrawing from an engagement or client relationship include appropriate documentation, it seems logical that any decision to withdraw from an engagement would be subject to those same consultation documentation procedures.

Communicating the Decision to Withdraw or Discontinue Services. A decision to withdraw or discontinue services is a serious matter and, consequently, communication of this decision (especially to the client) should be carefully considered. In most cases, it is a best practice for the communication to be in writing, such as in a resignation letter. In some cases, the firm may need to contact legal counsel to determine the most appropriate method of making this communication.

Accounting and Engagement Issues Form. The resolution of a technical question or problem through consultation should be documented, and it would be a best practice to have a standardized method for preparing such documentation. If so desired, the standardized method can also be used to document other significant findings or issues that do not require consultation. One method would be to use the form provided in *PPC's Guide to Compilation and Review Engagements*.

SELF-STUDY QUIZ

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

19. Which of the following features can be found in a typical general ledger (G/L) package of accounting software?

    a. Charts of accounts.

    b. Posting and period closing.

    c. Custom data entry.

    d. After-the-fact payroll.

20. Which of the following features is more typically found in write-up software than G/L software?

    a. General journal entries.

    b. Limited report options.

    c. Subsidiary modules for accounts and activities.

    d. Practice management modules.

21. James has been reviewing Mac-2's financial statements for the past ten years. The president of Mac-2 is a close friend. James performs no other engagements for Mac-2. His independence is most likely to be impacted by which of the following?

    a. The advocacy threat.

    b. The familiarity threat.

    c. The management participation threat.

    d. The self-review threat.

22. Which of the following CPAs can still be considered independent from his or her attest client?

    a. Ian executes transactions for his attest client.

    b. Julia prepares source documents for her attest client.

    c. Kevin performs ongoing monitoring of his attest client's internal controls.

    d. Laura serves as an expert witness for a group of plaintiffs including her attest client.

23. All of the following will impair an accountant's independence when performing nonattest services for a compilation or review client **except**:

    a. Assuming the responsibilities of management.

    b. Using a person without specified knowledge to oversee the services.

    c. Establishing an understanding with the client.

    d. Evaluating the adequacy and results of the services.

24. Which of the following statements best describes how an accountant or firm should proceed when there is a difference of opinion on an engagement?

    a. Any difference of opinion should be dealt with according to the specific circumstances of the engagement.

    b. Strict and detailed documentation requirements should be established so that all differences of opinion are properly recorded.

    c. It is more helpful to identify differences of opinion earlier in the engagement than later so next steps can be determined.

SELF-STUDY ANSWERS

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

19. Which of the following features can be found in a typical general ledger (G/L) package of accounting software? **(Page 218)**

    a. Charts of accounts. [This answer is incorrect. Many write-up packages contain master charts of accounts that can be tailored to the needs of individual clients. Master charts of accounts save time when setting up new clients. Write-up packages differ from G/L packages and often have different features.]

    b. Posting and period closing. [This answer is correct. G/L packages are integrated accounting programs. That is, the G/L software package often is linked with other modules or programs to comprise an entire accounting system. One feature of typical G/L package is posting and period closing. Transactions and journal entries can be entered when desired. After the entries for the period are entered, the period is closed (zeroed) and a new period is set up. Special routines are provided for closing the year-end and updating the retained earnings accounts. Transaction detail is normally lost after a year is closed.]

    c. Custom data entry. [This answer is incorrect. This is typically a feature of write-up software, not G/L software. Many write-up packages allow users to modify the screen displays used to enter transactions. Transaction data can be modified to be consistent with the layout of client documents, which can reduce the time spent entering data.]

    d. After-the-fact payroll. [This answer is incorrect. Many write-up packages (not G/L packages) have modules that record payroll transactions for updating the G/L and printing payroll tax forms such as W-2s, 940s, and 941s. The payroll capabilities may be standard features of the write-up program or add-on modules.]

20. Which of the following features is more typically found in write-up software than G/L software? **(Page 219)**

    a. General journal entries. [This answer is incorrect. One feature of G/L software is general journal entries (adjustments) that are usually entered in a separate journal. Explanations for entries are limited in most products. Journals of activity can be printed and summarized by account.]

    b. Limited report options. [This answer is incorrect. Most G/L packages print G/Ls and subsidiary journals. They also print financial statements, although the options for format and degree of detail may be limited. Many add-on modules generate special reports such as aged accounts receivable and perpetual inventory lists. However, the report writing software in G/L packages is different from that usually associated in write-up packages.]

    c. Subsidiary modules for accounts and activities. [This answer is incorrect. G/L software, not write-up software, is more likely to have subsidiary modules for major accounts and activities such as accounts receivable, accounts payable, inventory, and payroll. Although add-on modules are purchased separately, they link directly with the G/L. Consequently, transactions can be recorded in the G/L directly or through subsidiary modules.]

    d. Practice management modules. [This answer is correct. Some write-up packages includes time and billing modules and/or due date monitoring modules and other practice management features.]

21. James has been reviewing Mac-2's financial statements for the past ten years. The president of Mac-2 is a close friend. James performs no other engagements for Mac-2. His independence is most likely to be impacted by which of the following? **(Page 224)**

    a. The advocacy threat. [This answer is incorrect. This threat to independence is related to performing actions that promote an attest client's interests or position, such as representing a client in tax court, which is not the case in this scenario.]

b. The familiarity threat. [This answer is correct. Accountants who have close or longstanding relationships with attest clients, like James does with Mac-2, are most likely to be affected by the familiarity threat. James will need to take actions designed to mitigate this threat to retain his independence.]

c. The management participation threat. [This answer is incorrect. The management participation threat involves performing management functions on behalf of an attest client, such as making hiring decisions, which is not the case in this scenario.]

d. The self-review threat. [This answer is incorrect. The self-review threat involves reviewing your own nonattest work, or that of your team, as part of the attest engagement. There is no information in this scenario to imply that this is the case; therefore, there is a better answer to this question. However, in this engagement and others, James should be careful not to review his own work.]

22. Which of the following CPAs can still be considered independent from his or her attest client? **(Page 227)**

a. Ian executes transactions for his attest client. [This answer is incorrect. According to ET 1.295.030.02, exercising authority on behalf of a client, such as authorizing, executing, or consuming a transaction, or having the authority to do so, is considered a management responsibility and impairs a CPA's independence.]

b. Julia prepares source documents for her attest client. [This answer is incorrect. Preparing source documents, in electronic or other form, that evidence the occurrence of a transaction is considered a management responsibility under ET 1.295.030.02. Therefore, Julia's independence is impaired.]

c. Kevin performs ongoing monitoring of his attest client's internal controls. [This answer is incorrect. Performing ongoing evaluations of a client's internal controls as part of its monitoring activities is considered a management responsibility per ET 1.295.030.02. As such, Kevin's independence is impaired for this client.]

d. Laura serves as an expert witness for a group of plaintiffs including her attest client. [This answer is correct. Under ET 1.295.140 of the Code, certain types of forensic accounting services may impair independence. Independence is impaired if an accountant conditionally or unconditionally agrees to provide expert witness testimony for a client. However, under certain defined conditions, independence is not impaired if the accountant provides expert witness testimony for a large group of plaintiffs or defendants that includes the accountant's client. Therefore, if Laura meets all the necessary conditions, her independence will not be impaired with respect to her attest client.]

23. All of the following will impair an accountant's independence when performing nonattest services for a compilation or review client **except**: **(Page 228)**

a. Assuming the responsibilities of management. [This answer is incorrect. According to ET 1.295, if the accountant assumes management responsibilities, independence will be impaired.]

b. Using a person without specified knowledge to oversee the services. [This answer is incorrect. Under ET 1.295, for the accountant to maintain his or her independence, the client must oversee the service by designating an individual, preferably within senior management, who possesses suitable skills, knowledge and/or experience.]

c. Establishing an understanding with the client. [This answer is correct. Per ET 1.295, independence is impaired if the accountant does *not* establish the understanding with the client regarding (1) the objectives of the engagement, (2) the services to be performed, (3) the client's acceptance of its responsibilities, (4) the accountant's responsibilities, and (5) any limitations of the nonattest engagement.]

d. Evaluating the adequacy and results of the services. [This answer is incorrect. Under ET 1.295, for the accountant to maintain his or her independence, *the client* must evaluate the adequacy and results of the nonattest services provided.]

24. Which of the following statements best describes how an accountant or firm should proceed when there is a difference of opinion on an engagement? **(Page 235)**

    a. Any difference of opinion should be dealt with according to the specific circumstances of the engagement. [This answer is incorrect. QC 10.46 states that firms should establish policies and procedures for dealing with and resolving differences of opinion. Therefore, while the individual facts and circumstances of the disagreement will obviously play a part in how the situation is resolved, the accountant or firm has a basic starting place in the policies and procedures that will be applied to all such situations.]

    b. Strict and detailed documentation requirements should be established so that all differences of opinion are properly recorded. [This answer is incorrect. Conclusions reached when dealing with differences of opinion should be documented. Specific guidance regarding this documentation is not provided in QC 10 Care should be exercised in establishing policies and procedures for documenting differences of opinion. If the firm establishes documentation procedures that are too stringent, staff personnel may be discouraged from initiating general discussions of technical questions or issues for fear that these exchanges of ideas demand too much documentation time and effort.]

    c. It is more helpful to identify differences of opinion earlier in the engagement than later so next steps can be determined. [This answer is correct. If procedures for dealing with differences of opinion are effective, they will encourage identification of differences of opinion at an early stage. They will also provide clear guidelines about the successive steps to be taken thereafter.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Compilation and Review Engagements—Course 2—Engagement Administration (CARTG172)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $89 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     CARTG172 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you

complete three courses, the price for grading all three is $254 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $320 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $378 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked by **July 31, 2018**. CPE credit will be given for examination scores of 70% or higher.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Compilation and Review Engagements—Course 2—Engagement Administration (CARTG172)

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

1. Jasmine has accepted an engagement to review her client's financial statements in accordance with SSARS. She will need to do which of the following?

   a. Comply with all the requirements of all the AR-C sections.

   b. Understand all the text in relevant AR-C sections, including explanatory material.

   c. Comply with presumptively mandatory requirements in all circumstances.

   d. Make all professional judgments on her own, without soliciting opinions of those outside the engagement team.

2. Formal acceptance and continuance procedures can help a firm do which of the following?

   a. Increase its profitability.

   b. Increase its risk of legal exposure.

   c. Avoid working with clients who lack integrity.

   d. Determine acceptable reasons to keep all existing clients.

3. Breaker & Harmon CPAs has acceptance and continuance policies and procedures in place that align with QC 10. Which of the following engagements should the firm accept under such policies and procedures?

   a. Engagement 1 is lucrative, but it will require shorting other engagements on staff.

   b. Engagement 2 is for a client from whom the firm is not independent.

   c. Engagement 3 has a scope limitation imposed by the prospective client.

   d. Engagement 4 is offered by a business with an impeccable reputation.

4. If acceptance/continuance issues are identified, can the firm still accept the engagement?

   a. No, if issues arise, the firm is prohibited by SSARS from accepting the engagement.

   b. Yes, the firm can accept the engagement, but resolution of the issues must be documented.

   c. Yes, but the firm must inform the client that it will not be able to issue an unmodified opinion on the financial statements.

   d. Yes, the firm can accept the engagement and treat it just as it would any other engagement.

5. Compared to attest services, nonattest services typically do which of the following?

   a. Generate more revenue.

   b. Generate more costs.

   c. Subject the firm to more regulations.

   d. Subject the firm to increased risk.

6. The SSARS applies in which of the following situations? (All individuals are CPAs in public practice.)

   a. Alan submits a bid to compile the financial statements for his nonpublic client.

   b. Bridgette is engaged to review the financial statements of a public company.

   c. Carlos is engaged to perform nonattest bookkeeping services for a public company.

   d. Daria is engaged to compile the financial statements for a nonpublic company.

7. Which level of service is the most costly?

   a. Reviewed financial statements.

   b. Compiled financial statements that omit substantially all disclosures.

   c. Compiled financial statements with full footnote disclosures.

   d. Prepared financial statements.

8. Who is responsible for making the final decision about what the level of service the accountant will provide to the client?

   a. The accountant.

   b. The client's management.

   c. The client's accounting department.

   d. The client's legal counsel.

9. Josh's review client does not consider it cost-effective to adjust balances for inventory, the accounts receivable allowance, depreciation expense, and deferred taxes on its interim financial statements. How will this affect Josh's review report?

   a. The SSARS will not apply to this type of presentation, so Josh will not need to issue a full review report.

   b. The GAAP measurement departures should be ignored since third-party users will not use interim financial statements.

   c. The GAAP measurement departures should be referenced along with a statement that the effects are not determined.

   d. The dollar effects of the GAAP measurement departures should be calculated separately and included in the report.

10. Which of the following items would typically be included in an engagement letter for a review engagement, but not in an engagement letter for either a compilation or financial statement preparation engagement?

    a. Management's agreement that a statement indicating that no assurance was provided will be included on each page of the financial statements.

    b. A description of the auditor's responsibilities for selecting the applicable financial reporting framework applied in the preparation of the financial statements.

    c. A statement explaining the objectives of the engagement that will be performed.

    d. A note that, at the engagement's conclusion, management will provide the accountant a letter confirming certain representations.

11. Should engagement letters be renewed for continuing compilation or review engagements?

    a. Yes, SSARS require the engagement letter to be updated annually.

    b. Yes, though not required by SSARS, annual updates of an engagement letter is a best practice.

    c. No, since it is not required by SSARS, accountants should stick with the original engagement letter for continuity reasons.

    d. No, the engagement letter does not need to be updated every year, but it is a best practice to update it at least every three years.

12. *Mediation* involves which of the following?

    a. A neutral facilitator.

    b. Evidentiary rulings.

    c. Lengthy face-to-face meetings.

    d. Imposing sanctions.

13. Which of the following would be considered a step-down?

    a. Going from a financial statement preparation to a compilation.

    b. Going from a financial statement preparation to a review.

    c. Going from a compilation to a review.

    d. Going from an audit to a review.

14. When does the *subsequent period* occur?

    a. From being approached by the client to engagement acceptance.

    b. From the planning phase to the conclusion of the engagement.

    c. From the balance sheet date to when management issues the financial statements.

    d. From the date management issues the financial statements to the beginning of the next year's engagement.

15. After completing a review engagement, Peggy discovers facts that would have caused her to believe the information provided by her client was incomplete. Peggy's client decides not to notify users about any problems with the financial statements. After going through the appropriate steps, Peggy decides that she needs to notify users that the financial statements cannot be relied on. Which of the following should she do?

    a. Notify appropriate regulatory agencies that her report should not be used.

    b. Notify the client that they have only a limited time in which to associate her report with the financial statements.

    c. Notify third-party users with a description of her clients conduct and motives.

    d. Request that the client notify all parties known to be using the financial statements that neither the financial statements nor the report should be used.

16. What is the best way for accountants to prepare engagement documentation for compilation and review engagements to ensure engagement quality?

    a. To prepare it as the engagement progresses.

    b. To prepare it before the engagement, as much as possible.

    c. To prepare it after the engagement is complete.

    d. To prepare it according to the specific documentation requirements in the SSARS.

17. According to this course, which of the following is most significant regarding how workpapers should be filed?

    a. All workpapers are filed in one place.

    b. Electronic workpapers should be filed separately from manual workpapers.

    c. All workpapers and documents should be filed and readily available when needed.

    d. Workpapers are filed according to the type of service.

18. Which of the following statements correctly addresses an issue related to engagement documentation in compilation and/or review engagements?

    a. Because it is not addressed in the SSARS, accountants should not purge compilation and review documentation.

    b. Accountants who sell their firm have a special exemption from the need to maintain client confidentiality.

    c. Even a firm that has achieved a completely paperless method for performing engagements may need paper documentation for regulatory purposes.

    d. Under the SSARS, accounting firms are required to retain all compilation and review engagement documentation for a minimum of ten years.

19. What is the requirement for communicating with a predecessor accountant under the SSARS?

    a. Communicating with a predecessor is mandatory.

    b. Communicating with a predecessor is prohibited.

    c. Communicating with a predecessor is allowed at the successor's discretion.

    d. Communicating with a predecessor is allowed at the client's discretion.

20. What is a CPA firm's first line of defense against litigation?

    a. Professional liability insurance.

    b. Loss prevention.

    c. Engagement letters.

    d. Quality control.

21. Which of the following is one protective measure used to minimize the impact of any claims or potential claims against the firm?

    a. Engagement letters.

    b. Damage control.

    c. Quality control.

    d. Professional liability insurance.

22. What is an accountant's responsibility for fraud and noncompliance in a review engagement?

    a. The accountant must comply with the requirements laid out in AU-C 240 and 250, just as he or she would do in an audit engagement.

    b. The accountant is required to document his or her assessment of fraud as outlined in the SSARS performance standards.

    c. The accountant needs to obtain limited assurance about whether the financial statements are free of material misstatement due to fraud, noncompliance, or error.

    d. The accountant is exempt from any responsibility related to fraud or noncompliance in review engagements. Management has all responsibilities in SSARS engagements.

23. What type of entity is most likely to use a privity doctrine?

    a. An S corporation.

    b. A nonpublic company.

    c. A bank or financial institution.

    d. A governmental entity.

24. Quality control systems are designed to promote quality in relation to what types of engagements?

    a. Accounting and auditing engagements.

    b. Tax engagements.

    c. Consultation engagements.

    d. Agreed-upon procedures engagements.

25. What type of documentation does a compilation and review firm need for its quality control policies and procedures?

    a. Documentation that meets the strict requirements laid out in QC 10.

    b. The same type of documentation (form and content) as used by an audit firm.

    c. A formal quality control and procedures document.

    d. Documentation that best suits its individual practice and circumstances.

26. The CPA firm of Clemson & Braun performs a new type of engagement that brings with it a higher level of risk than their typical engagements (Engagement A). The engagement does not meet the firm's criteria for an engagement quality control review (EQCR). It also performs an engagement that meets the EQCR standards, but that had no problems and low associated risks (Engagement B). How should the firm proceed?

    a. It should perform an EQCR on Engagement A instead of on Engagement B.

    b. It should perform an EQCR on Engagement B, but not on Engagement A.

    c. It should perform EQCRs on both Engagement A and Engagement B.

    d. It should perform the required EQCR on Engagement B and consider also performing one on Engagement A.

27. When performing an engagement under the SSARS, who is primarily responsible for ensuring that all engagement-level quality control procedures under AR-C 60 are met?

    a. An elected member of the engagement team.

    b. The engagement partner.

    c. Senior managers or partners of the CPA firm.

    d. The firm's managing partner.

28. Compilation and review firms typically undergo what kind of peer review?

    a. An engagement review.

    b. A system review.

    c. An EQCR.

    d. Compilation and review firms do not undergo peer review.

29. Which of the following statements best describes an engagement review?

    a. The peer reviewer forms an opinion on the firm's quality control system.

    b. The report provides assurance solely on the firm's engagements.

    c. The peer reviewer will need to review administrative and personnel files.

    d. The peer reviewer will not need to look at client financial statements.

30. The Joint Ethics Enforcement Program (JEEP) does which of the following?

    a. Performs peer reviews for member firms.

    b. Revokes member's licenses for reasons of professional misconduct.

    c. Joint enforcement of AICPA and state society codes of conduct.

    d. Keeps investigation information segregated between the AICPA and state societies.

31. What is the biggest advantage of using write-up software as compared to general ledger (G/L) software?

    a. The report writing feature.

    b. A design compatible for a single business.

    c. Active account processing.

    d. Do not select this answer choice.

32. What is the purpose of a web portal?

    a. Data from a client's computer system can be imported.

    b. Software is maintained by the vendor and the CPA logs in online.

    c. Use of a computer as a central file server.

    d. Better security of clients' confidential information.

33. Which of the following makes a software package easier to use?

    a. A long and detailed client set-up process.

    b. Software specific to a single computer workstation.

    c. Single key strokes to repeat data.

    d. A package that is sold, not licensed.

34. What type(s) of report(s) can a CPA issue on the financial statements of a nonpublic entity if his or her independence is impaired?

    a. Compilation.

    b. Review.

    c. Compilation and review.

    d. CPAs are prohibited from issuing any reports on financial statements if they are not independent.

35. Where are the primary independence rules located?

    a. The AICPA *Code of Professional Conduct* (Code).

    b. A firm's quality control materials.

    c. QC 10.

    d. The SSARS.

36. Which of the following firms has implemented a safeguard to protect the independence of its members?

    a. Members of Firm A take continuing professional education related to ethics.

    b. Firm B rotates the senior personnel assigned to attest engagement teams.

    c. Firm C has its quality control system peer reviewed.

    d. Firm D only works with clients who seem committed to fair financial reporting.

37. Which of the following CPAs will no longer be independent from his or her attest client?

    a. Marjory fulfilled the independence requirements of ET 1.295, as well as those imposed by an applicable regulatory body.

    b. Nelson's client chooses an employee to oversee the nonattest work that does not have a level of technical expertise that matches Nelson's.

    c. Olivia accepts a review engagement for a client for whom she previously provided bookkeeping services without a written understanding.

    d. Patrick accepts the responsibility of signing his client's checks, but only in emergency situations.

38. Under what circumstances would an accountant be most likely to document a consultation on a compilation or review engagement?

    a. The engagement will result in a standard report.

    b. This is a first time application of a new pronouncement.

    c. No material litigation exists relating to the issue.

    d. This is the first time that the report has been issued.

39. Using the technical manuals in a firm's library to research an engagement issue is an example of which of the following?

    a. An in-firm consultation.

    b. An outside firm consultation.

    c. A difference of opinion.

    d. An independence issue.

40. Jacob is engaged to review his client's financial statements. Under what circumstances would the SSARS require him to withdraw from the engagement?

    a. He will have to modify his review report to adequately indicate the deficiencies in his client's financial statements.

    b. A complex matter arises, and to resolve it Jacob will have to consult someone outside of his firm.

    c. His client calls and asks a question about a routine technical matter. Jacob proceeds to give his attest client advice.

    d. His client refuses to provide a representation letter and Jacob cannot issue a compilation report.

GLOSSARY

Alternative dispute resolution (ADR): A way of attempting to resolve client disputes without exposing the firm to the cost and uncertainty of litigation. Common methods include arbitration and mediation. ADR generally takes less time and has a better chance of preserving the client/accountant relationship than litigation.

Arbitration: A type of ADR in which parties present their respective cases to an arbitrator (or a panel of arbitrators) who renders a verdict at the conclusion of the case. The arbitrator acts as both judge and jury by making evidentiary rulings, ordering discovery, and imposing sanctions in addition to deciding the issues in the case.

Attest engagement: According to the AICPA *Code of Professional Conduct*, this is an engagement that requires independence. Examples include audits, examinations, agreed-upon procedures engagements, reviews, and compilations.

Confidential client information: Per the AICPA *Code of Professional Conduct*, this is information that is not available to the public.

Dedicated write-up packages: Accounting software packages written with write-up engagements in mind. They are generally designed for after-the-fact accounting and include reporting features not found in *G/L packages*.

Engagement driven: When a standard, such as SSARS No. 21, only applies if an accountant in public practice is engaged to prepare, compile, or review the financial statements of a nonpublic entity. Without the engagement, the standard would not apply to the accountant.

Foreseeability standard: A standard adopted by Wisconsin and Mississippi that permits any person whose reliance upon the accountant's report could have been reasonably foreseen at the time the report was issued to assert a claim based upon a negligence standard.

Fraud: Per the SSARS, this is an intentional act that causes a misstatement in the financial statements.

General ledger (G/L) packages: Integrated accounting software packages designed for active accounting processing (including such functions as generating sales invoices, checks, etc.).

Mediation: A type of ADR in which voluntary settlement negotiations are facilitated by a neutral party. No resolution is imposed on the disputing parties by the neutral party.

Nonattest services: Accounting services provided to clients, such as staff accountant work, bookkeeping, and serving as controllers and CFOs. They are often long-term services, and they may cause the loss of independence and the ability to provide attest services.

Noncompliance: Per the SSARS, this is intentional or unintentional violations of laws or governmental regulations, excluding *fraud*.

Presumptively mandatory requirement: An accountant must comply with this type of SSARS requirement if it is relevant to the engagement, except in rare situations discussed in AR-C 60.16. SSARS use the word *should* to indicate a presumptively mandatory requirement.

Privity doctrine: As held by the New York State Court of Appeals in *Ultramares v. Touche*, a CPA firm can only be sued on a negligence theory by those persons with whom the CPA firm had entered into a contractual or privity relationship (i.e., the CPA firm's client). Sixteen states follow this doctrine, and each does so in its own way.

Professional judgment: Reasonable judgments and informed decisions about matters affecting an engagement made by an accountant with appropriate training, knowledge, and experience.

Quality control elements: The elements that must be addressed by the policies and procedures in a firm's quality control system: leadership responsibilities for quality within the firm, relevant ethical requirements, acceptance and continuance of client relationships and specific engagements, human resources, engagement performance, and monitoring.

Quality control materials (QCM): A system of practice aids—engagement aids (e.g., accounting and auditing manuals), checklists, questionnaires, work programs, computer-aided accounting and auditing tools, and similar materials—used to assist firms in performing and reporting in conformity with professional standards.

Restatement standard: As held in the *Restatement (Second) of the Law of Torts*, published by the American Law Institute in 1977, this standard generally permits a negligence claim against an accountant to be asserted by any person whom the accountant knew at the time he or she issued the report would be relying upon the report. Twenty-three states have adopted this standard, and each have different interpretations.

Safeguards: Controls that mitigate or eliminate threats to independence. They can be created by the profession, legislation, or regulations; implemented by the attest client; or implemented by the firm.

Step-down: Changing an engagement to a lower level of service after it has begun (e.g., from an audit to a review).

Step-up: Changing an engagement to a higher level of service after it has begun (e.g., from a compilation to a review).

Subsequent period: The period between the balance sheet date and management's issuance of the financial statements.

Type I events: Subsequent events that provide additional evidence about conditions that existed at the balance sheet date and that affect the estimates inherent in preparing financial statements. Also called *recognized subsequent events*.

Type II events: Subsequent events that did not exist at the balance sheet date, but that arose after the balance sheet date but before the financial statements are issued or are available to be issued. Also called *nonrecognized subsequent events*.

Unconditional requirement: An accountant must always comply with this type of SSARS requirement, if the requirement is relevant to the engagement. SSARS use the word *must* to indicate an unconditional requirement.

Undertaking-to-be-truthful clause: An engagement letter clause that is an agreement by the client to be truthful, accurate, and complete in making representations to the firm. This type of clause may be helpful in litigation, such as defending against a breach of conduct claim.

Write-up services: Automated accounting services accountants can provide to clients, including processing payrolls, summarizing data for tax returns, and maintaining accounts receivable or accounts payable ledgers.

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COMPANION TO PPC'S GUIDE TO COMPILATION AND REVIEW ENGAGEMENTS

COURSE 3

INTERIM ENGAGMENTS, SPECIAL PURPOSE FRAMEWORKS, AND PERSONAL FINANCIAL STATEMENTS (CARTG173)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course takes a look at several topics that can affect compilation and review engagements. Lesson 1 discusses how interim engagements can differ from engagements to compile or review annual financial statements. Lesson 2 examines how special purpose frameworks can affect the financial statements. Finally, Lesson 3 discusses personal financial statements.
PUBLICATION/REVISION DATE:	July 2017
RECOMMENDED FOR:	Users of *PPC's Guide to Compilation and Review Engagements*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of accounting
CPE CREDIT:	6 NASBA Registry "QAS Self-Study" Hours This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.
FIELD OF STUDY:	Accounting
EXPIRATION DATE:	Postmark by **July 31, 2018**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Interim Engagements

Completion of this lesson will enable you to:

- Identify the types of forms and checklists commonly used in interim compilation and review engagements and the general accounting rules for interim financial statements.
- Determine the appropriate methods for dealing with revenue recognition, inventory and cost of goods sold, other costs and expenses, income taxes, unusual or infrequent items, and disposal of a component in interim financial statements.
- Recognize when to correct interim financial statements for a prior period, the types of accounting changes that may affect interim financial statements, what disclosures are required for interim financial statements, and how to deal with various reporting issues that might arise in this type of engagement.

Lesson 2—Financial Statements Presented in Accordance with a Special Purpose Framework

Completion of this lesson will enable you to:

- Identify the different types of special purpose frameworks, how they fit in with the accounting standards, when to use a special purpose framework, and how different bases of accounting are used.

- Recognize the statement titles that are appropriate under the cash and tax basis, how various financial statements will be affected if a special purpose framework is used; applicable presentation considerations; and how to deal with disclosures, cash to accrual conversions, engagement and representation letters, and reporting issues.

Lesson 3—Personal Financial Statements

Completion of this lesson will enable you to:

- Determine what entity is covered by personal financial statements, the basis of the presentation, the form and content of the presentation, and how to use the estimated current value basis of accounting.
- Recognize the typical elements of personal financial statement engagements, including those specific to both compilations and reviews, and how to deal with reporting issues for such engagements.
- Assess common issues related to personal financial statement engagements using a variety of case studies.

TO COMPLETE THIS LEARNING PROCESS:

Submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

- Email to: *CPLGrading@thomsonreuters.com*
- Fax to: **(888) 286-9070**
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Chicago, IL 60694-6700

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

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Interim Engagements

INTRODUCTION

This lesson discusses unique GAAP measurement and disclosure principles and unusual reporting situations relating to interim financial statements. It is designed to provide answers to some of the less complex applications of GAAP and to help the practitioner recognize more complex GAAP problems as they relate to interim statements.

PPC's Guide to Compilation and Review Engagements includes information about the PPC quality control system, as well as checklists and forms which can be used as a firm's quality control materials (QCM) for performing compilation and review engagements. Some of those checklists and forms either apply to or can be adapted to use for interim engagements.

Forms and checklists are not included in the *Companion to PPC's Guide to Compilation and Review Engagements* CPE workbook; however, if the guidance in this course pertains to the checklists or forms, they may be mentioned. More information, as well as the checklists and forms themselves, can be found in *PPC's Guide to Compilation and Review Engagements*.

If a firm has a quality control system, it is a best practice for that firm to use some type of QCM when performing compilation and review engagements, even if that QCM is not based on the checklists and forms provided in the PPC guide. Therefore, even if the specific checklist mentioned in this lesson is not used by the firm, the guidance provided in this lesson may apply to a similar form in the firm's existing quality control system.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the types of forms and checklists commonly used in interim compilation and review engagements and the general accounting rules for interim financial statements.
- Determine the appropriate methods for dealing with revenue recognition, inventory and cost of goods sold, other costs and expenses, income taxes, unusual or infrequent items, and disposal of a component in interim financial statements.
- Recognize when to correct interim financial statements for a prior period, the types of accounting changes that may affect interim financial statements, what disclosures are required for interim financial statements, and how to deal with various reporting issues that might arise in this type of engagement.

RECOMMENDATIONS FOR INTERIM COMPILATION AND REVIEW ENGAGEMENTS

Are Interim Engagements Subject to Peer Review?

Yes. Compilations and reviews of interim financial statements are subject to peer review. In fact, many peer reviewers will make a point of selecting at least one interim compilation engagement with disclosures, one interim compilation engagement without disclosures, and one interim review engagement to get a cross section of a firm's accounting and auditing engagements. As a result, a firm's quality control policies and procedures should be designed to include its interim engagements. If a firm has different requirements for interim and year-end engagements, those differences should be reflected in its quality control policies and procedures so the staff knows what is expected on each engagement.

Since interim engagements are subject to peer review, some firms apply the same quality control policies and procedures to interim engagements as they do to year-end engagements. However, other firms elect less stringent documentation requirements for their interim engagements, particularly interim compilation engagements.

Using Forms and Checklists in Interim Compilation Engagements

As previously discussed, it is a best practice for firms to use forms and checklists when performing interim compilation engagements. Firms could choose to create their own forms and checklists or use those from a third-party provider—whatever is consistent with the firm's quality control system. The following paragraphs provide this course's recommendations related to workpapers firms may use in their interim compilation engagements; however, it is not an exhaustive list.

Engagement Acceptance and Continuance. Firms need to assess potential clients and reevaluate existing clients. If the interim engagement is the first financial statement engagement the firm has performed for the client, it is a best practice to use some type of engagement acceptance and continuance form. Otherwise, such a form would only need to be updated (or a new form completed) if there is a need to reevaluate whether to continue performing the engagement. However, a sign off or some type of documentation should be made each period to indicate that consideration has been given to whether or not anything has changed that would require reevaluation.

Engagement Letters. AR-C 80.10 requires accountants to establish an understanding with management regarding the services to be performed for a compilation engagement and to document this understanding with an engagement letter. In addition, AR-C 80.11 also requires that the understanding with the client be signed by both the accountant or accountant's firm and management or those charged with governance. It is unnecessary to obtain a separate engagement letter for each interim engagement.

Compilation Procedures, Review, and Approval. This course and *PPC's Guide to Compilation and Review Engagements* recommend certain minimum steps as necessary to comply with SSARS and to pass peer review. It is a best practice to make sure all such steps are completed for year-end compilation engagements and interim compilation engagements that include disclosures. Different steps would be appropriate for recurring interim compilations that omit substantially all disclosures. Users of *PPC's Guide to Compilation and Review Engagements* will find Compilation Procedures, Review, and Approval forms that outline these steps. Other firms might use similar types of forms to make sure all necessary steps are performed. If a firm uses such forms, they should be included in the workpapers.

Client Information. This information is gathered once and updated annually. Staff performing an interim engagement need only read the information to ensure that they have the required knowledge of the client.

Compilation Reporting. There are common SSARS reporting requirements for financial statement compilations. It is a best practice for these checklists to be completed for at least the first interim compilation of the year. No matter what method is used, reporting information should be included in the workpapers.

Disclosure Checklists. At least a short-form disclosure checklist should be prepared on every engagement that includes disclosures. (If the compiled financial statements omit all disclosures, such a checklist is unnecessary.) If the firm chooses not to prepare a checklist for every interim engagement that includes disclosures, one should at least be prepared for the first interim period to address unusual reporting situations that often are encountered on interim engagements, such as those discussed later in this lesson. In subsequent interim periods, the staff and partner must be alert for situations that might require changes to footnotes or additional disclosures. Consequently, the firm may choose to require completion of at least a short-form checklist for each interim period (unless disclosures are omitted).

Documenting Procedures in Interim Compilation Engagements

There are numerous ways that firms can choose to document the performance of compilation procedures in interim engagements. Several examples are discussed in this section, including forms and checklists provided in *PPC's Guide to Compilation and Review Engagements*. Firms might also choose to use other forms and checklists for their interim compilation engagements, as previously discussed.

Completing an Interim Summarized Form. If a firm has different policies for year-end and interim engagements, it will usually find that time can be saved by having a separate, shorter form for interim compilation engagements. That can be done for several reasons, including the following:

a. Some of the procedures applicable to annual engagements are rarely applicable to interim engagements.

b. Some procedures are done routinely.

c. Some procedures are done annually and need only be updated at each interim period.

d. For many clients, the financial statements and accountant's report change little, if any, from one interim period to the next.

e. Most firms do recurring work for their clients in which interim compilation engagements are just one aspect of a continual service that is provided (e.g., year-end financial statements, interim financial statements, and tax planning and compliance work). Consequently, those firms are usually very familiar with the client's operations and aware of changes in the client's circumstances.

Using a summarized form can provide increased efficiency without reducing quality. However, firms should use summarized forms with caution. If procedures are omitted from a firm's procedures for regular compilation engagements, firms must be able to demonstrate that the applicable requirements have been met. The burden for considering omitted steps falls on the preparer. Therefore, those preparing the forms for interim engagements should be familiar with all the steps in the checklists the firm uses for year-end engagements.

Other Alternatives. Other alternatives for documenting compilation procedures in interim engagements include (a) in an electronic environment, such as with *PPC's Practice Aids*™, simply adding a column for each period or (b) adding additional partner and in-charge sign-off blocks to the bottom of the first compilation procedures form for the year. Under either of the scenarios, changes in steps performed or results achieved can be referenced to a memo in the workpapers.

Another way in which a firm can document completion of compilation procedures in an interim engagement is to prepare a memo indicating that the most recent checklist has been reviewed and noting any changes. Although that approach might appear to be more efficient, it also might be an open invitation to omit certain necessary steps. Consequently, using memos in place of checklists is not recommended by this course.

Special Considerations for the First Interim Period. Certain presentation, reporting, and disclosure situations are often encountered in interim engagements that are encountered less often in year-end engagements. For example, interim statements often:

a. Include supplementary information that may not be included in year-end statements.

b. Omit substantially all disclosures and the statement of cash flows.

c. Contain GAAP departures that may not be present in year-end financial statements (e.g., lack of an income tax accrual or failure to adjust inventories).

Firms may choose to require that the same forms and checklists be completed for both year-end engagements and the first interim engagement of each year. It seems likely, however, that the unique aspects of interim engagements can be dealt with by having an engagement quality control review performed on a client's first interim compilation of the year.

Special Considerations for Twelfth-month Interim Statements. A firm's normal forms for recurring interim engagements may include sign-off columns for 12 interim periods. However, using such sign-offs is not recommended when financial statements include disclosures. Likewise, such forms should not be used if twelfth-month statements without disclosures are issued as a draft to be followed up with full disclosure statements. This situation sometimes occurs if clients want year-end information quickly, but also want full-disclosure year-end financial statements, particularly if the year-end statements are reviewed or audited.

Partner Review on Recurring Interim Engagements. Some CPAs question whether a partner review is required for compilation engagements, especially recurring interim compilation engagements. AR-C 60.21 requires the engagement partner on a SSARS engagement to take responsibility for:

- the overall quality of the engagement;
- ensuring the direction, supervision, planning, and performance of the engagement comply with professional standards and legal and regulatory requirements;

- the appropriateness of the reports; and
- ensuring the engagement is performed in accordance with firm quality control policies and procedures.

However, AR-C 60.07 says the engagement partner can be a partner or other person in the firm who is responsible for the engagement, its performance, and the report and has the appropriate professional and legal authority.

Using Forms and Checklists in Interim Review Engagements

Like with interim compilation engagements, it is also a best practice for firms to use checklists and forms when performing interim review engagements. One method for doing so is to use the forms and checklists provided in *PPC's Guide to Compilation and Review Engagements*. As previously discussed, other methods could also be used as consistent with the firm's quality control system.

Unlike compilation engagements, the forms used for interim review engagements are essentially the same as those used for annual review engagements. The following paragraphs provide this course's recommendations related to workpapers firms might use in their interim review engagements; however, it is not an exhaustive list.

Engagement Acceptance and Continuance Form. Firms need to assess potential clients and reevaluate existing clients. A form for this purpose should be completed in an interim engagement if it is the first financial statement engagement the firm has performed for the client. Otherwise, such a form only needs to be updated (or a new form completed) if there is a need to reevaluate whether to continue performing the engagement. However, a sign off or some type of documentation should be made each period to indicate that consideration has been given to whether or not anything has changed that would require reevaluation.

Engagement Letters. AR-C 90.11 requires accountants to establish an understanding with management regarding the services to be performed for a review engagement and to document this understanding with an engagement letter. In addition, AR-C 90.12 also requires the understanding with the client be signed by both the accountant or accountant's firm and management or those charged with governance. It is unnecessary to obtain a separate engagement letter for each interim engagement.

Inquiry and Analytical Procedures Program. Certain inquiries and analyses are normally performed in typical review engagements. Although completion of a checklist is not required to meet SSARS or peer review requirements, it is a best practice to complete one for all review engagements, regardless of the size of the accounting firm.

Review Procedures, Review, and Approval. This course and *PPC's Guide to Compilation and Review Engagements* recommend certain minimum steps as necessary to comply with SSARS and to pass peer review. It is a best practice to make sure all such steps are completed on all year-end review engagements and interim review engagements. Users of *PPC's Guide to Compilation and Review Engagements* will find Review Procedures, Review, and Approval forms that outline these steps. Other firms might use similar types of forms to make sure all necessary steps are performed. If a firm uses such forms, they should be included in the workpapers.

Client Information Form. This information should be prepared once and updated annually. Staff performing an interim engagement need only read the information to ensure that they have the required knowledge of the client.

Letters of Representation. AR-C 90.34 requires written representations from management for all financial statements and periods covered by the accountant's review report. A separate management representation letter should be obtained for each interim review engagement.

Review Reporting Checklist. There are common SSARS reporting requirements for financial statement reviews. If PPC materials are used, it is a best practice for these checklists to be completed for at least the first interim review of the year. No matter what method is used, reporting information can be included in the workpapers.

Disclosure Checklists. Disclosure checklists should be prepared on every engagement. If the firm chooses not to prepare such a checklist for every interim review engagement, one should at least be prepared for the first interim period to address unusual reporting situations that often are encountered on interim engagements, such as those discussed later in this lesson. In subsequent interim periods, the staff and partner must be alert for situations that might require changes to footnotes or additional disclosures. Consequently, the firm may choose to require completion of at least a short-form checklist for each interim period.

THE ACCOUNTING RULES FOR INTERIM FINANCIAL STATEMENTS

FASB ASC 270-10, 250-10, and 740-270, and International Accounting Standard (IAS) 34, *Interim Financial Reporting*, are the existing applicable accounting guidance for interim financial statements. This lesson is not a substitute for a thorough understanding of these pronouncements, and the practitioner should consult these technical references.

In accordance with AR-C 90.02, SSARS are not applicable to reviews of interim financial information if all of the following conditions are met:

a. The entity's latest annual financial statements have been audited by the accountant or a predecessor.

b. The accountant has been engaged to audit the entity's current year financial statements or when it is expected that the current year financial statements will be audited, the appointment of another accountant to audit the current year financial statements is not effective prior to the period covered by the review.

c. The entity prepares its interim financial information using the same financial reporting framework as that used to prepare its annual financial statements.

In these instances, the accountant should perform the interim reviews in accordance with AU-C 930, *Interim Financial Information*. *PPC's Guide to Audits of Nonpublic Companies* contains guidance and practice to assist auditors in applying the provisions of AU-C 930.

The SSARS imply that an accountant is permitted to prepare interim financial statements using a different financial reporting framework than that used to prepare its year-end statements when performing the interim review in accordance with the SSARS. For example, an accountant performing a SSARS review for a client may use a special purpose framework for preparing its interim financial statements and generally accepted accounting principles (GAAP) for preparing its annual statements. This is not allowed for accountants preparing interim financial statements in accordance with AU-C 930.

When the same basis of accounting is used to prepare both interim and year-end statements, however, each interim period should be viewed as an integral part of an annual period. The results of each interim period should be based on the accounting principles and practices used by the company in preparing its latest annual financial statements, unless a change in an accounting practice or policy has been adopted in the current year.

In certain situations, various accounting principles and practices followed for annual reporting purposes might require modification at interim dates so that the reported results for the interim period better relate to the annual results of operations. The following sections discuss some of the "dos and don'ts" as they relate to the preparation of interim financial statements.

SELF-STUDY QUIZ

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

1. Which of the following accountants has correctly addressed an issue related to interim compilation engagements?

    a. Allison obtains a new engagement letter for every interim compilation with the same client.

    b. Bryant does not obtain documentation that engagement acceptance and continuance procedures for an interim engagement were evaluated for changes.

    c. Carla prepares at least a short-form disclosure checklist for every interim compilation that includes disclosures.

    d. Dwayne does not include a reporting checklist for the interim compilation since the reporting requirements do not apply.

2. Why might a firm use a shorter form for interim compilation engagements than it does for year-end compilations?

    a. The same types of procedures apply to both types of engagements.

    b. The accountant's report is likely to change significantly between the two.

    c. Firms are unlikely to be familiar enough with interim clients to fill out a longer form.

    d. Annual procedures may not need to be reperformed at interim periods.

3. What are the requirements for letters of representation in an interim review engagement?

    a. Letters of representation are not required.

    b. The letter of representation for the year-end review is sufficient.

    c. A letter of representation can be obtained for the first interim review engagement only.

    d. A letter of representation is needed for every interim review engagement.

4. Assuming all other conditions are met, which review of interim financial information is **not** subject to the SSARS?

    a. Whammy Inc's latest annual financial statements were compiled by the same accountant.

    b. Jessica is engaged to perform both an interim review and a current-year annual audit for her client.

    c. Thomas elects not to fill out a disclosure checklist for an interim review engagement.

    d. Baker's Dozen uses the income tax basis for its interim statements and GAAP for its annual statements.

SELF-STUDY ANSWERS

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

1. Which of the following accountants has correctly addressed an issue related to interim compilation engagements? **(Page 262)**

   a. Allison obtains a new engagement letter for every interim compilation with the same client. [This answer is incorrect. AR-C 80.10 requires accountants to establish an understanding with management regarding the services to be performed for a compilation engagement and to document this understanding with an engagement letter. However, it is unnecessary to obtain a separate engagement letter for each interim engagement. Therefore, Allison is not using the most efficient method to meet her engagement letter requirements.]

   b. Bryant does not obtain documentation that engagement acceptance and continuance procedures for an interim engagement were evaluated for changes. [This answer is incorrect. Firms need to assess potential clients and evaluate existing clients, even for interim engagements. The procedures should be performed each period and sign off or some type of documentation made indicating consideration was given for reevaluation.]

   c. Carla prepares at least a short-form disclosure checklist for every interim compilation that includes disclosures. [This answer is correct. Disclosure checklists should be prepared on every engagement that includes disclosures. If the firm chooses not to prepare a checklist for every interim engagement that includes disclosures, one should at least be prepared for the first interim period to address unusual reporting situations that are often encountered on interim engagements. In subsequent interim periods, the staff and partner must be alert for situations that might require changes to footnotes or additional disclosures. Consequently, the firm may choose to require completion of at least a short-form checklist for each interim period. Therefore, Carla has been appropriately thorough in filling out her checklists.]

   d. Dwayne does not include a reporting checklist for the interim compilation since the reporting requirements do not apply. [This answer is incorrect. Common SSARS reporting requirements apply to both interim and year-end engagements. Therefore, Dwayne should include such a checklist for the first interim compilation of the year, at a minimum.]

2. Why might a firm use a shorter form for interim compilation engagements than it does for year-end compilations? **(Page 262)**

   a. The same types of procedures apply to both types of engagements. [This answer is incorrect. Some of the procedures applicable to annual engagements are rarely applicable to interim engagements.]

   b. The accountant's report is likely to change significantly between the two. [This answer is incorrect. For many clients, the financial statements and accountant's report change little, if any, from one interim period to the next.]

   c. Firms are unlikely to be familiar enough with interim clients to fill out a longer form. [This answer is incorrect. Most firms do recurring work for their clients in which interim compilation engagements are just one aspect of a continual service that is provided. Consequently, those firms are usually very familiar with the client's operations and aware of changes in the client's circumstances.]

   d. Annual procedures may not need to be reperformed at interim periods. [This answer is correct. If a firm has different policies for year-end and interim engagements, it will usually find that time can be saved by having a separate, shorter form for interim compilation engagements. This can be done for several reasons, including the fact that some procedures are done annually and only need to be updated (not reperformed) at each interim period.]

3. What are the requirements for letters of representation in an interim review engagement? **(Page 264)**

   a. Letters of representation are not required. [This answer is incorrect. AR-C 90.34 requires written representations from management for all financial statements and period covered by the accountant's review report. Therefore, if a letter of representation is not obtained, the accountant will not be in compliance with the requirements.]

   b. The letter of representation for the year-end review is sufficient. [This answer is incorrect. Based on the guidance in AR-C 90.34, it is not appropriate for an interim review engagement to rely on the representation letter for the year-end review.]

   c. A letter of representation can be obtained for the first interim review engagement only. [This answer is incorrect. There are certain workpapers for which this would be sufficient; however, this does not meet the AR-C 90.34 requirements for representation letters in interim review engagements.]

   d. A letter of representation is needed for every interim review engagement. [This answer is correct. Based on the guidance in AR-C 90.34, a separate management representation letter should be obtained for each interim review engagement.]

4. Assuming all other conditions are met, which review of interim financial information is **not** subject to the SSARS? **(Page 265)**

   a. Whammy Inc's latest annual financial statements were compiled by the same accountant. [This answer is incorrect. According to AR-C 90.02, SSARS will not be applicable to a review of interim financial information if the entity's latest annual financial statements were audited (not compiled) by the accountant or a predecessor. Therefore, Whammy Inc.'s interim review will be subject to SSARS.]

   b. Jessica is engaged to perform both an interim review and a current-year annual audit for her client. [This answer is correct. Per AR-C 90.02, one condition that must be met for an interim review engagement to be exempt from the SSARS is that the accountant has also been engaged to audit the entity's current year financial statements. The appointment of another accountant to audit the current year statements cannot be effective prior the period covered by the review.]

   c. Thomas elects not to fill out a disclosure checklist for an interim review engagement. [This answer is incorrect. It is a best practice for disclosure checklists to be filled out for every engagement, or at least for the first interim period. However, whether or not a disclosure checklist is used is not one of the conditions laid out in AR-C 90.02 which would make the SSARS not applicable to an interim review.]

   d. Baker's Dozen uses the income tax basis for its interim statements and GAAP for its annual statements. [This answer is incorrect. Based on the guidance in AR-C 90.02, the SSARS would not be applicable if the entity prepares its interim financial information using the same financial reporting framework as that used to prepare its annual financial statements. Since Baker's Dozen uses a different financial framework for its interim statements, they will be subject to SSARS.]

REVENUE RECOGNITION IN INTERIM FINANCIAL STATEMENTS

Revenue from products sold or services rendered should be recognized as earned on the same basis as followed for the full year. Generally, this means that revenue should be recognized at an interim period only after goods are delivered (title passes) or when a service is rendered and completed.

Occasionally, application of the general revenue recognition policy used at year end distorts interim revenue. The word *distorts* is used here to mean that if the revenue figure on the interim statement was annualized, it would not bear a reasonable relation to the actual annual sales. For instance, a job-order manufacturing company that customarily derives its revenue from a small number of large jobs that take several months to complete might find that shipments, and thus revenue, would vary significantly from month to month. Nevertheless, FASB ASC 270 requires that interim period revenue be recognized on the same basis as followed for the full year. Supplementary information detailing sales backlog and jobs in progress could be useful disclosures in the situation described above.

A company whose business is highly seasonal has similar problems with distorted interim revenue. Again, FASB ASC 270 offers no relief to the accounting method used. It does, however, require disclosure of the seasonal nature of the company's business.

If interim financial statements are based on a revenue recognition policy other than that used in year-end statements, the accountant's report should disclose the departure from GAAP.

DEALING WITH INVENTORY AND COST OF GOODS SOLD IN INTERIM FINANCIAL STATEMENTS

Some of the more prevalent difficulties encountered in preparing interim financial statements are concerned with inventory valuation and the related effect on cost of goods sold. Frequently, it is not feasible to obtain inventory values by physical count at interim balance sheet dates. Likewise, operations for a period shorter than a year can produce illogical results if normal year-end procedures are followed in application of inventory methods such as LIFO, standard costs, and lower of cost or market. The following paragraphs discuss these inventory-related problem areas and offer guidance.

Gross Profit Method

The gross profit method is the most common method of estimating inventories at interim dates when physical inventories are not taken. The use of this method to determine inventory and cost of goods sold, although not acceptable in annual statements, is an acceptable method for use in interim financial statements (FASB ASC 270). However, the use of estimated gross profit rates should be disclosed in the financial statements. For example:

> NOTE A—INVENTORY AND COST OF GOODS SOLD
>
> The Company measures inventory and cost of goods sold for interim financial statements by use of a historically developed gross profit percentage. Annually, the Company adjusts the inventory to reflect the results of a physical count.

Because the method is authorized by FASB ASC 270 for interim financial statements, it is not a departure from GAAP; thus, the accountant's report need not be modified.

Market Declines

The practitioner should be alert to situations where the market value of inventory at the interim balance sheet date is below cost or net realizable value. Even when the gross profit method is used, it may be obvious to the practitioner that market is below cost or net realizable value. *Temporary* declines in the market value of inventory to values below cost (for LIFO or the retail inventory method inventories) or net realizable value (for all other inventories) need not be recognized in interim financial statements if the market decline can reasonably be expected to be restored *by the end of the fiscal year*. If, however, the company cannot reasonably expect a decline at an interim date to reverse itself by year end, the inventory should be adjusted to market value (for LIFO or the retail inventory method inventories) or net realizable value (for all other inventories) at the interim date. A subsequent recovery in value before year end should be recognized in the interim period during which the recovery takes place. However, the inventory, once adjusted downward to market, should not be written up above original cost.

LIFO Inventory Approximations

For companies that have adopted the LIFO inventory method, two general approaches are used to value inventory at interim dates. One approach is to compute interim LIFO inventory values based on the actual quantities and inventory costs at the interim date. In other words, the same LIFO valuation technique used at year end is applied at the interim date. Such an exacting calculation can be very time-consuming, especially if a physical inventory must be taken. Accordingly, a precise interim calculation of LIFO values is normally not made in practice. The alternative is to use an estimation technique to arrive at interim LIFO values. Estimation techniques used in practice range from sophisticated calculations that consider management's estimates of changes in product mix, prices, and inventory levels to simple calculations based on historical LIFO gross profit percentages. (The latter approach parallels the use of gross profit percentages discussed above.) When an estimation technique has been used, this fact should be disclosed along with a description of the technique. For example:

> NOTE A—INVENTORIES
>
> Inventories are valued at the lower of cost or market. Cost is determined by the last-in, first-out (LIFO) method. Natural business pool indexes for determining adjustments to LIFO are computed annually based on a double-extended physical inventory. At interim balance sheet dates, the published consumer price indexes are used to estimate LIFO adjustments.

For some companies, use of a consumer price index to determine LIFO values may be GAAP. In this illustration, the indexes are used to estimate values determined by other methods consistently followed in the annual financial statements.

Some companies only compute LIFO inventory values annually and value interim inventories on a FIFO basis. The accountant should consider the following in such circumstances:

a. If the difference between LIFO and FIFO values as of the interim date is known to be immaterial, the accountant may find it acceptable to identify the inventories as LIFO.

b. If the difference is material and the statements are issued with inventories on a FIFO basis, the statements are not in accordance with GAAP (because they do not use the same method as used in the year-end statements), and the accountant's report should note the departure. The accountant should also be concerned about violating various IRS regulations regarding LIFO, particularly Reg. 1.472-2(e)(6), which holds that, in certain cases, a series of interim statements presenting results of operations on a non-LIFO basis constitutes presentation of annual results on a non-LIFO basis.

LIFO Inventory Liquidations

When companies encounter a liquidation of a LIFO layer in an interim period, a determination must be made as to whether the liquidation is temporary or permanent. If the liquidation is permanent, the interim period financial statements should disclose the effect on net income resulting from the liquidation.

If the liquidation is temporary, the inventory at the interim reporting date should not give effect to the LIFO liquidation, and consequently, the pretax income effect of the liquidation should be recorded as a current liability in an account captioned "Unearned income from temporary LIFO liquidations." The temporary nature of the liquidation should be disclosed in the financial statements.

Standard Cost System

The same procedures used for annual statements should, generally, be followed in application of standard cost systems for interim statement purposes. Planned variations expected to be absorbed by the end of the fiscal year should ordinarily be deferred in interim financial statements. Unanticipated variances that are not expected to be absorbed should, however, be reported in interim financial statements.

OTHER COSTS AND EXPENSES THAT MAY AFFECT INTERIM FINANCIAL STATEMENTS

FASB ASC 270 lists four general principles that should be observed when determining charges for other costs and expenses in the interim financial statements:

a. Costs and expenses other than product costs should be charged to income in interim periods as incurred or be allocated among interim periods based on an estimate of time expired, benefit received, or activity associated with the periods. Procedures adopted for assigning specific cost and expense items to an interim period should be consistent with the basis followed by the company in reporting results of operations at annual reporting dates. However, when a specific cost or expense item charged to expense for annual reporting purposes benefits more than one interim period, the cost or expense item may be allocated to those interim periods.

b. Some costs and expenses incurred in an interim period, however, cannot be readily identified with the activities or benefits or other interim periods and should be charged to the interim period in which incurred. Disclosure should be made as to the nature and amount of such costs, unless items of a comparable nature are included in both the current interim period and in the corresponding interim period of the preceding year.

c. Arbitrary assignment of the amount of such costs to an interim period should not be made.

d. Gains and losses that arise in any interim period similar to those that would not be deferred at year end should not be deferred to later interim periods within the same fiscal year.

A complete listing of examples of application of these standards is not practical; however, the following examples from FASB ASC 270 may be helpful:

a. When a cost that is expensed for annual reporting purposes clearly benefits two or more interim periods, e.g., annual major repairs, each interim period should be charged for an appropriate portion of the annual cost by the use of accruals or deferrals.

b. When quantity discounts are allowed customers based upon annual sales volume, the amount of such discounts charged to each interim period should be based on the sales to customers during the interim period in relation to estimated annual sales.

c. Property taxes (and similar costs such as interest and rent) may be accrued or deferred at the annual reporting date to achieve a full year's charge of taxes to costs and expenses. Similar procedures should be adopted at each interim reporting date to provide an appropriate cost in each period.

d. Advertising costs may be deferred within a fiscal year if the benefits of an expenditure clearly extend beyond the interim period in which it is made. Advertising costs may be accrued and assigned to interim periods in relation to sales prior to the time the service is received if the advertising program is clearly implicit in the sales arrangements. Further discussion regarding advertising costs is found in FASB ASC 720-35.

The amounts of certain costs and expenses are frequently subjected to year-end adjustments even though they can be reasonably approximated at interim dates. Such adjustments should be estimated and the estimated costs and expenses assigned to interim periods so that the interim periods bear a reasonable portion of the anticipated annual amount. Examples of such items include inventory shrinkage, allowance for bad debts, allowance for quantity discounts, discretionary year-end bonuses, profit-sharing contributions, and depreciation.

ACCOUNTING FOR INCOME TAXES IN INTERIM FINANCIAL STATEMENTS

FASB ASC 740 emphasizes the balance sheet by focusing on what the current and deferred liabilities and assets should be at the balance sheet date. Under this method, referred to as the *liability method*, the income tax provisions are the residuals of the changes in the balance sheet accounts from period to period. In addition, tax benefits of net losses are recognized currently if they more likely than not will be recognized. Consequently, in some cases, companies may record deferred tax assets even though book and tax income are the same.

Normally, GAAP for income taxes in annual financial statements applies to interim statements as well. However, the basic principle that interim statements should be viewed as an integral part of an annual period necessitates some special techniques in accounting for income taxes in interim financial statements. These techniques are discussed in the following paragraphs.

Accounting Requirements

The basic premise underlying interim financial reporting is that interim periods are an integral part of an annual period, and annual results should be allocated to interim periods. Under that view, interim income tax provisions related to "ordinary income or loss" are determined using an estimated annual effective tax rate (or tax benefit rate) that is based on estimated annual results. The interim tax effect of "ordinary income or loss" is determined as follows:

a. Estimate "ordinary income or loss" for the year and calculate the related income tax provision.

b. Determine the estimated annual effective tax rate (or tax benefit rate) by dividing the income tax provision for the year by estimated "ordinary income or loss" for the year.

c. Determine the year-to-date tax provision or benefit by multiplying year-to-date "ordinary income or loss" by the estimated annual effective tax rate. (See the discussion later in this section, however, for certain limitations that must be considered in calculating the tax benefit of losses.)

d. Subtract the tax provision related to "ordinary income or loss" through the preceding interim period from the provision calculated in step c. to determine the tax effect to report in the current interim period.

PPC's Guide to Accounting for Income Taxes provides worksheets for calculating interim period income taxes. That *Guide* can be ordered by calling (800) 431-9025 or at **tax.thomsonreuters.com**.

Certain revenues and expenses, however, that are directly related to a specific interim period, including items such as significant unusual or infrequently occurring items and discontinued operations should be reported in the interim period in which they occur and, accordingly, should not be prorated over the balance of the fiscal year.

Interim Income Taxes When *Ordinary Income* Is Estimated for the Year

This course suggests that both the current and deferred components of the annual provision related to *ordinary income* should be determined to be consistent with the liability method. They recommend the following procedures for determining the estimated annual effective tax rate related to *ordinary income*:

a. Estimate the current provision for the year by applying enacted tax rates to estimated taxable *ordinary income* for the year. (That amount should consider the alternative minimum tax system.)

b. Estimate the deferred tax provision for the year by calculating the deferred tax effect of estimated temporary differences, tax loss carryforwards, and tax credit carryforwards at the end of the year and subtracting it from the balance at the beginning of the year.

c. Determine the total estimated tax provision for the year by adding the results of steps a. and b.

d. Divide the results obtained in step c. by the estimated *ordinary income* for the year to determine the estimated annual tax rate for the year.

To illustrate the calculation, assume the following facts:

a. Year-to-date *ordinary income* at the end of the current interim period of $80,000.

b. Year-to-date income tax provision through the end of the preceding interim period of $5,000.

c. Taxable temporary differences at the beginning of the year of $100,000; estimated taxable temporary differences at the end of the year of $150,000.

d. Tax rates are 15% on the first $50,000 and 25% on the excess.

e. Average graduated tax rate expected to be in effect when temporary differences reverse of 15%.

f. Estimated annual *ordinary income* of $130,000, including permanent differences related to tax-exempt income of $27,600.

The first step in calculating an interim tax provision is to estimate the current income tax provision for the year by applying enacted tax rates to estimated taxable *ordinary income* for the year. Estimated taxable *ordinary income* is determined by estimating *ordinary income* for the year and adjusting for permanent and temporary differences:

Estimated *ordinary income* for the year	$ 130,000
Estimated permanent differences for the year	(27,600)
Estimated temporary differences for the year (estimated taxable differences of $150,000 at the end of the year less differences of $100,000 at the beginning of the year)	(50,000)
Estimated taxable *ordinary income* for the year	$ 52,400
Estimated current income tax provision ($52,400 × regular tax rates)	$ 8,100

The deferred income tax provision for the year would be estimated as follows:

Estimated deferred tax liability at the end of the year (estimated taxable temporary differences of $150,000 × 15%)	$ 22,500
Deferred tax liability at the beginning of the year (taxable temporary differences of $100,000 × 15%)	15,000
Estimated deferred tax provision for the year	$ 7,500

The estimated annual tax rate is 12%, which is determined by dividing the estimated annual income tax provision of $15,600 (current provision of $8,100 plus deferred provision of $7,500) by estimated annual *ordinary income* of $130,000. The interim tax provision would be determined as follows:

Year-to-date *ordinary income*	$ 80,000
Estimated annual tax rate	12 %
Year-to-date income tax provision through the end of the current interim period	$ 9,600
Year-to-date income tax provision through the end of the preceding interim period	5,000
Income tax provision for the current interim period	$ 4,600

Interim Income Taxes When *Ordinary Income* Is Estimated for the Year But There Is an Interim Loss

If a company has a year-to-date *ordinary loss*, the tax benefit that may be recognized in the interim period is limited to the amount that more likely than not will be realized. If *ordinary income* is estimated for the year, realization of the tax benefits of the interim loss can be considered more likely than not. Thus, the annual effective tax rate should be applied to the total year-to-date *ordinary loss* to determine the interim year-to-date tax benefit.

Interim Income Taxes When an *Ordinary Loss* Is Estimated for the Year

Calculating interim income taxes when an *ordinary loss* is expected for the year varies depending on the year-to-date results.

a. If there is year-to-date *ordinary income*, year-to-date taxes are calculated by multiplying the year-to-date *ordinary income* by the estimated annual tax benefit rate.

b. If there is year-to-date *ordinary loss* that is less than the estimated *ordinary loss* for the year, a deferred tax asset should be recognized at the interim date if the tax benefits of the loss are expected to be recognizable as a deferred tax asset at the end of the year. That limitation is accomplished by reflecting the tax effect of the expected year-end valuation allowance in the effective tax rate.

c. If there is year-to-date *ordinary loss* that exceeds the estimated *ordinary loss* for the year, the year-to-date tax benefit is the lesser of (1) the amount calculated by applying the estimated annual tax benefit rate to the year-to-date *ordinary loss* or (2) the tax benefit obtained by applying the estimated annual tax benefit rate to *ordinary income* for the remainder of the year that is more likely than not plus the tax benefit of the excess loss that can be carried back to taxable income of prior years and the tax benefit of any remaining excess loss that is recognizable as a deferred tax asset at the end of the year. That limitation is accomplished by substituting the year-to-date *ordinary loss* for the estimated annual *ordinary loss*.

To illustrate, assume the following facts:

- The company is in its second year of operations.
- Estimated annual *ordinary loss* is $50,000.
- Year-to-date *ordinary loss* is $70,000.
- Tax rates are 15% on the first $50,000 and 25% on the excess.
- The average graduated tax rate expected to apply to reversals of temporary differences is 17%.

The year-to-date tax benefit would be calculated as follows:

YEAR-TO-DATE TAX BENEFIT USING ESTIMATED ANNUAL TAX BENEFIT RATE

	Prior Taxable Income	Current Year	Future Taxable Income
ANNUAL INCOME CALCULATION USING ESTIMATED ANNUAL *ORDINARY LOSS*			
Annual "ordinary income (loss)"		$ (50,000)	$ 5,000
Taxable reversals		20,000	60,000
Taxable "ordinary income (loss)"	$ 45,000	(30,000)	65,000
Carryback of taxable *ordinary loss*	(30,000)	30,000	—
	$ 15,000	$ -0-	$ 65,000
CALCULATION OF TAX BENEFIT OF ESTIMATED ANNUAL *ORDINARY LOSS*			
Current benefit from carrying back the estimated annual taxable *ordinary loss* of $30,000		$ (4,500)	
Deferred tax benefit			
Ending deferred tax liability ($60,000 × 17%)		10,200	
Beginning deferred tax liability ($80,000 × 17%)		13,600	
		(3,400)	

YEAR-TO-DATE TAX BENEFIT USING ESTIMATED ANNUAL TAX BENEFIT RATE

	Prior Taxable Income	Current Year	Future Taxable Income
Estimated annual tax benefit		$ (7,900)	
CALCULATION OF ESTIMATED ANNUAL TAX BENEFIT RATE			
Estimated annual tax benefit of $7,900 ÷ estimated annual *ordinary loss* of $50,000		16%	
TAX BENEFIT FROM APPLYING THE ANNUAL TAX BENEFIT RATE TO THE YEAR-TO-DATE *ORDINARY LOSS*			
Preliminary year-to-date tax benefit ($70,000 × 16%)		$ 11,200	

YEAR-TO-DATE TAX BENEFIT CONSIDERING LOSS RECOGNITION LIMITATIONS

	Prior Taxable Income	Current Year	Future Taxable Income
ANNUAL INCOME CALCULATION SUBSTITUTING YTD "ORDINARY LOSS" FOR ESTIMATED ANNUAL *ORDINARY LOSS*			
YTD "ordinary income (loss)"		$ (70,000)	$ 5,000
Taxable reversals		20,000	60,000
Taxable "ordinary income (loss)"	$ 45,000	(50,000)	65,000
Carryback of taxable *ordinary loss*	(45,000)	45,000	—
Offset of taxable *ordinary loss* against future taxable income	—	5,000	(5,000)
	$ -0-	$ -0-	$ 60,000
CALCULATION OF YTD TAX BENEFIT LIMITATION			
Current benefit from carrying back $45,000 of the year-to-date taxable *ordinary loss*		$ (6,750)	
Deferred tax benefit			
Ending net deferred tax liability [($60,000 × 17%) − ($5,000 × 17%)]		9,350	
Beginning deferred tax liability ($80,000 × 17%)		13,600	
		(4,250)	
YTD tax benefit limitation		$ (11,000)	

Since the second calculation—the year-to-date tax benefit considering loss recognition limitations—yields the lower amount, the financial statements would report a year-to-date tax benefit of $11,000.

Prior-year Operating Loss Carryforwards

Loss carryforwards are treated consistently in interim and annual financial statements. The tax benefits of loss carryforwards generally are recognized in the year that the loss occurs. Tax benefits would not be recognized in the prior year for a loss that was incurred that year. However, if the related deferred tax asset were offset by a valuation allowance, realization of an operating loss carryforward that is attributable to losses in prior years is included in the computation of the estimated annual effective tax rate the same as, for example, tax credit carryforwards.

GAAP does not include any specific guidelines for recognizing the effect of prior-year loss carryforwards in determining the annual effective tax rate. The following steps may be helpful:

a. Add year-to-date *ordinary income* and estimated *ordinary income* for the remainder of the year that is more likely than not to determine the maximum prior-year tax loss carryforward that can be offset against estimated *ordinary income* for the year.

b. Apportion the maximum amount from the preceding step between taxable income and temporary differences based on estimated annual results.

c. If the carryforward is less than the maximum calculated in the preceding step, apportion it between taxable income and temporary differences based on the allocation in the preceding step.

Note that the preceding discussion deals with previously unrecognized tax benefits, which would only arise if prior-year carryforwards were not recognized as a deferred tax asset. If the net operating loss carryforward in step a. exceeds estimated *ordinary* income for the year, the calculation is the same except that the need for a valuation allowance must be evaluated for the loss carryforward at the end of the year.

Accounting for Changes in Tax Rates or New Tax Legislation

Deferred tax assets and liabilities in both annual and interim financial statements are required to be adjusted for the effects of changes in tax laws or rates in the period that includes the enactment date, that is, for federal tax purposes, the period in which the President signs the legislation and it becomes law.

For interim reporting, it is not acceptable to allocate the effects of the changes to subsequent interim periods by adjusting the annual effective tax rate for the remainder of the year. Thus, in any interim period that includes a change, the tax provision will have two components: (a) the adjustment of the deferred tax asset or liability for the enacted changes and (b) the remainder. However, unlike annual financial statements, interim financial statements are not required to disclose the components.

The estimated deferred tax provision for the year should be based on the newly enacted laws. The difference between the year-to-date tax provision and the provision reported through the end of the preceding interim period should be reported as the provision for the current interim period. It does not seem necessary to recompute the deferred tax asset or liability as of the end of the prior interim period or to calculate the adjustment of the deferred tax asset or liability because of the enacted changes at the interim reporting date.

Disclosure Considerations

The only required disclosure related to interim income tax provisions is the reasons for significant variations in the customary relationship between income tax expense and pretax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the company's business. The financial statements need not disclose the current and deferred components of the interim provision.

Classifying Deferred Tax Balance Sheet Accounts

GAAP does not discuss how to allocate or classify an interim income tax provision to components of current and noncurrent taxes payable. The objective of FASB ASC 270 and 740-270 is to allocate annual results to interim periods. It is best practice that the interim income tax provision should be charged or credited to current and noncurrent amounts in a classified balance sheet based on estimated annual results.

Following the recommendations in this course for calculating the interim tax provision will provide estimates of the total tax provision for the year and its current and deferred components. Generally, those two amounts will be added together in determining the estimated annual effective tax rate and may be used to allocate the year-to-date interim income tax provision to the appropriate income tax balance sheet accounts as follows:

a. Divide the estimated total current provision for the year by the estimated total provision for the year, and multiply the result by the year-to-date total tax provision to determine the total year-to-date current provision. The resulting amount is the adjustment to refundable or accrued income taxes, and the balance ordinarily is classified as current.

b. Subtract the result of step a. from the total year-to-date tax provision to determine the total year-to-date deferred tax provision.

c. Determine the current and noncurrent portions of the estimated deferred tax asset or liability at the end of the year, and calculate the estimated change in the current and noncurrent balances from the beginning of the year to the end of the year.

d. Divide the change in the current deferred tax asset or liability by the total estimated deferred tax provision for the year, and multiply the result by the total year-to-date deferred tax provision from step b. to determine the adjustment to the current deferred tax asset or liability.

e. Subtract the result of step d. from the total year-to-date deferred tax provision in step b. to determine the adjustment to the noncurrent deferred tax asset or liability.

To illustrate, assume that the total year-to-date tax provision is $50,000, and the annual income tax provision is estimated as follows:

Estimated total current provision for the year		$ 60,000	60 %
Estimated total deferred provision for the year			
Ending liability	$ 90,000		
Beginning liability	50,000	40,000	40 %
Total provision		$ 100,000	100 %

The current and deferred components of the total year-to-date provision based on the calculation of the total estimated provision for the year would be determined as follows:

Total year-to-date provision	$ 50,000
Current portion ($50,000 × 60%)	30,000
Deferred portion	$ 20,000

The next step would be to determine the change in the deferred tax asset and liability accounts. The change would be calculated as follows (using assumed balances):

	Beginning	**Estimated Ending**	**Change**	
Deferred tax accounts:				
Current asset	$ (10,000)	$ —	$ 10,000	
Current liability	—	20,000	20,000	
			30,000	75 %
Noncurrent liability	60,000	70,000	10,000	25 %
	$ 50,000	$ 90,000	$ 40,000	100 %

The current and noncurrent deferred tax liabilities based on the estimated changes during the year would be determined as follows:

Total year-to-date deferred tax provision	$ 20,000
Change in the current deferred tax liability ($20,000 × 75%)	15,000
Change in the noncurrent deferred tax liability	$ 5,000

Since there was an opening current deferred tax asset and the balance classified as current at the end of the year is expected to be a liability, it seems logical for the year-to-date deferred provision to first be applied against the asset until it is eliminated. Any remainder would be credited to a deferred tax liability account. In the preceding illustration, the $10,000 opening balance of the current deferred tax asset would be eliminated, and a current deferred tax liability of $5,000 would be recorded for the difference.

DEALING WITH UNUSUAL OR INFREQUENT ITEMS AND THE DISPOSAL OF A COMPONENT OF AN ENTITY

Unusual or Infrequent Items (or Both)

FASB ASC 225-20-45-16 requires material events or transactions that are either unusual or infrequent or both to be presented in the income statement as separate elements of income from continuing operations. The income statement presentation should *not* be presented net of tax as separate line items following income from continuing operations. The nature and effects of the events or transactions should be presented as separate component income from continuing operations on the face of the income statement or in the notes to the financial statements.

The following are examples of events or transactions that may be considered as unusual or infrequent or both—

- Catastrophic events and natural disasters.
- Write-down or write-off of receivables, inventories, equipment leased to others, or intangible assets.
- Gains or losses from sale or abandonment of property, plant, or equipment used in business.
- Gains or losses from exchange or translation of foreign currencies including those relating to major devaluations and revaluations.
- Effects of a strike, including those against competitors and major suppliers.
- Adjustments of accruals on long-term contracts.
- Proceeds from life insurance of an officer.
- Environmental remediation obligations.

Component of an Entity

The phrase *component of an entity* refers to the operations and cash flows of an entity that can be clearly distinguished from the rest of the entity. A component of an entity may be in the form of a reportable segment or an operating segment (as defined in FASB ASC 280-10-50-1), a reporting unit (as defined in FASB ASC 350-20-35-33 through 35-38), a subsidiary, or an asset group (as defined in FASB ASC 360-10-20). (See FASB ASC 360-10 for additional guidance.)

Financial Statement Presentation

The following principles should be applied to unusual or infrequent items and disposal of a component of an entity in interim financial statements:

a. Material unusual or infrequent items, and gains and losses on disposal of a component of an entity should be recognized in the interim period in which they occur. They should not be prorated over the fiscal year.

b. For unusual or infrequent items and discontinued operations, materiality should be related to the interim period in which they occur.

c. Discontinued operations should be presented as a separate line item on a net-of-tax basis in interim statements.

d. Material unusual or infrequent items should also be presented as separate line items. However, they should be presented as a component of income from continuing operations and should not be net of tax. The related tax expense or benefit should be included in the income tax expense or credit related to continuing operations.

e. If more than one of the preceding items exists, the appropriate order of presentation in the income statement is as follows: (1) income from continuing operations including unusual or infrequent items and (2) discontinued operations of a component of an entity.

f. The tax expense or benefit associated with unusual or infrequent items is computed as the incremental tax from adding the unusual or infrequent items to *ordinary income*. As noted in item d., the incremental tax should be added to the tax on ordinary income from continuing operations in order to obtain the income tax expense for the period.

g. The tax expense or benefit associated with the disposal of a component of an entity is likewise the incremental tax or benefit. However, the resulting incremental tax or benefit is netted against the gain or loss on disposal or from discontinued operations, rather than becoming a part of income tax expense or credit for the period.

SELF-STUDY QUIZ

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

5. Which of the following statements most accurately describes an issue related to inventory and the cost of goods sold in interim financial statements?

   a. The gross profit method can only be used in interim statements if it is also used in annual statements.

   b. Entities do not have to recognize temporary declines in value if they will be restored by year end.

   c. Because the use of LIFO estimation techniques is so common, it is not necessary to disclose it in the financial statement notes.

   d. Planned variations in the standard cost systems that will be absorbed by year end should be recognized and disclosed in interim statements.

6. Which of the following is a general principle that should be observed when charges for other costs and expenses in the interim financial statements are determined?

   a. Information about other costs and expenses that are charged to the interim period in which they occurred should typically be disclosed.

   b. Other costs and expenses can be charted to interim periods arbitrarily if specific conditions are met.

   c. Gains and losses that arise in any interim period can be deferred to any other interim period, no matter their treatment in the year-end statements.

   d. Product costs are charged to income in interim periods as they occur or are allocated among interim periods.

7. Paisley Products has the following financial information as of the current interim period:

Year-to-date ordinary income:	$160,000
Year-to-date income tax provision through the preceding interim period:	$10,000
Taxable temporary differences at the beginning of the year:	$200,000
Estimated taxable temporary differences at the end of the year:	$300,000
Tax rates:	15% on the first $50,000; 25% on the excess
Average graduated tax rate expected to be in effect when temporary differences reverse:	15%
Estimated annual ordinary income:	$260,000
Permanent differences related to tax-exempt income:	$55,200

   What is Paisley Products' income tax provision for the current interim period?

   a. $12,400.

   b. $15,000.

   c. $21,200.

   d. $104,800.

8. Which of the following is true concerning unusual and/or infrequent items?

   a. They should be presented as separate elements of income from continuing operations.

   b. Events must be both usual and infrequent in order to be presented as separate elements of income.

   c. Income statement presentation of unusual or infrequent items should be presented net of tax.

9. If either (1) unusual or infrequent items or (2) disposal of a component of an entity affect interim financial statements, which of the following principles would apply?

   a. Material amounts should be prorated over the fiscal year.

   b. Material infrequent or unusual items should be presented as separate line items.

   c. If both occur, the discontinued operations of a component entity should be presented first on the income statement.

   d. The materiality of infrequent or unusual items should be determined based on annual amounts.

SELF-STUDY ANSWERS

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

5. Which of the following statements most accurately describes an issue related to inventory and the cost of goods sold in interim financial statements? **(Page 270)**

   a. The gross profit method can only be used in interim statements if it is also used in annual statements. [This answer is incorrect. The use of the gross profit method to determine inventory and cost of goods sold is *not* acceptable in annual statements. However, it is acceptable in interim financial statements, per FASB ASC 270.]

   b. Entities do not have to recognize temporary declines in value if they will be restored by year end. [This answer is correct. *Temporary* declines in the market value of inventory to values below cost or net realizable value need not be recognized in interim financial statements if the market decline can reasonably be expected to be restored *by the end of the fiscal year*.]

   c. Because the use of LIFO estimation techniques is so common, it is not necessary to disclose it in the financial statement notes. [This answer is incorrect. Estimation techniques used in practice range from sophisticated calculations that consider management's estimates of changes in product mix, prices, and inventory levels to simple calculation based on historical LIFO gross profit percentages. When an estimation technique has been used, this fact should be disclosed along with a description of the technique. No LIFO estimation technique is so common as to not need this disclosure.]

   d. Planned variations in the standard cost systems that will be absorbed by year end should be recognized and disclosed in interim statements. [This answer is incorrect. The same procedures used for annual statements should, generally, be followed in application of standard cost systems for interim statement purposes. Planned variations expected to be absorbed by the end of the fiscal year should ordinarily be deferred in the interim financial statements. Unanticipated variances that are not expected to be absorbed should, however, be reported in the interim financial statements.]

6. Which of the following is a general principle that should be observed when charges for other costs and expenses in the interim financial statements are determined? **(Page 272)**

   a. Information about other costs and expenses that are charged to the interim period in which they occurred should typically be disclosed. [This answer is correct. FASB ASC 270 lists four general principles that should be observed when determining charges for other costs and expenses in the interim financial statements. One of those principles is that if some costs and expenses incurred in an interim period cannot be readily identified with the activities or benefits or other interim periods, they should be charged to the interim period in which incurred. Disclosure should be made as to the nature and amount of such costs, unless items of a comparable nature are included in both the current interim period and in the corresponding interim period of the preceding year.]

   b. Other costs and expenses can be charted to interim periods arbitrarily if specific conditions are met. [This answer is incorrect. Based on the general principles in FASB ASC 270, arbitrary assignment of the amount of costs to an interim period that cannot be readily identified with activities or benefits or other interim periods should not be made.]

   c. Gains and losses that arise in any interim period can be deferred to any other interim period, no matter their treatment in the year-end statements. [This answer is incorrect. Per FASB ASC 270, gains and losses that arise in any interim period similar to those that would not be deferred at year end should not be deferred to later interim periods within the same fiscal year.]

   d. Product costs are charged to income in interim periods as they occur or are allocated among interim periods. [This answer is incorrect. According to FASB ASC 270, costs and expenses *other than product costs* should be charged to income in interim periods as incurred or be allocated among interim periods based on an estimate of time expired, benefit received, or activity associated with the periods.]

7. Paisley Products has the following financial information as of the current interim period:

Year-to-date ordinary income:	$160,000
Year-to-date income tax provision through the preceding interim period:	$10,000
Taxable temporary differences at the beginning of the year:	$200,000
Estimated taxable temporary differences at the end of the year:	$300,000
Tax rates:	15% on the first $50,000; 25% on the excess
Average graduated tax rate expected to be in effect when temporary differences reverse:	15%
Estimated annual ordinary income:	$260,000
Permanent differences related to tax-exempt income:	$55,200

What is Paisley Products' income tax provision for the current interim period? **(Page 273)**

a. 12,400. [This answer is correct. Paisley Products' estimated annual tax rate is 14%, which is determined by dividing the estimated annual income tax provision of $36,200 (current provision of $21,200 plus deferred provision of $15,000) by the estimated annual ordinary income of $260,000. Then the interim tax provision is calculated as ($160,000 × .14) – $10,000 = $12,400.].

b. $15,000. [This answer is incorrect. This is Paisley Products' estimated deferred tax provision for the year. It is calculated as the estimated deferred tax liability at the end of the year (estimated taxable temporary differences of $300,000 × 15%) minus the deferred tax liability at the beginning of the year (taxable temporary differences of $200,000 × 15%). Numerically, that calculation is ($300,000 × .15) – ($200,000 × .15) = $15,000. This amount will be used in the calculation of the company's income tax provision for the current interim period, but other information and calculations will be needed, as well.]

c. $21,200. [This answer is incorrect. This is Paisley Products' estimated current income tax provision. It is calculated by taking the estimated taxable ordinary income for the year ($104,800) and multiplying it by the regular tax rates listed above. Numerically, that calculation is (.15 × $50,000) + {.25 × ($104,800 – $50,000)} = $21,200. To determine the company's income tax provision for the current interim period, further calculations will be required.]

d. $104,800. [This answer is incorrect. This is Paisley Products' estimated taxable ordinary income for the year. It is calculated as estimated ordinary income for the year minus estimated permanent difference for the year minus estimated temporary differences for the year (estimated taxable differences of $300,000 less differences of $200,000). Numerically, that calculation is $260,000 – $55,200 ($300,000 – $200,000) = $104,800. Further calculations are needed to determine the company's income tax provision for the current interim period.]

8. Which of the following is true concerning unusual and/or infrequent items? **(Page 277)**

   a. They should be presented as separate elements of income from continuing operations. [This answer is correct. FASB ASC 225-20-45-16 requires material events or transactions that are infrequent and/or unusual to be presented as separate elements of income and not be combined with continuing operations.]

   b. Events must be both usual and infrequent in order to be presented as separate elements of income. [This answer is incorrect. According to FASB ASC 225-20-45-16 material events or transactions that are either usual or infrequent or both must be presented separately.]

   c. Income statement presentation of unusual or infrequent items should be presented net of tax. [This answer is incorrect. Per FASB ASC 225-20-45-16, the income statement presentation of such items should not be presented net of tax as separate line items following income from continuing operations.]

9. If either (1) unusual or infrequent items or (2) disposal of a component of an entity affect interim financial statements, which of the following principles would apply? **(Page 280)**

   a. Material amounts should be prorated over the fiscal year. [This answer is incorrect. Material unusual or infrequent items and gains and losses on disposal of a component of an entity should be recognized in the interim period in which they occur, *not* prorated over the fiscal year.]

   b. Material infrequent or unusual items should be presented as separate line items. [This answer is correct. Material unusual or infrequent items should be presented as separate line items. However, they should be presented as a component of income from continuing operations and should not be net of tax. The related tax expense or benefit should be included in the income tax expense or credit related to continuing operations.]

   c. If both occur, the discontinued operations of a component entity should be presented first on the income statement. [This answer is incorrect. If more than one of the preceding items exists (i.e., unusual or infrequent items and disposal of a component entity), the appropriate order of presentation in the income statement is as follows: (1) income from continuing operations including unusual or infrequent items and (2) discontinued operations of a component of an entity.]

   d. The materiality of infrequent or unusual items should be determined based on annual amounts. [This answer is incorrect. For unusual or infrequent items and discontinued operations, materiality should be related to the interim period in which they occur.]

WHEN PRIOR PERIOD INTERIM FINANCIAL STATEMENTS SHOULD BE CORRECTED

It is appropriate to restate prior period interim financial statements only in the event that either of the following types of items is present:

a. Items qualifying as *prior period adjustments* as defined in FASB ASC 250-10-45-25 and 45-26; 270-10-45-17 and 45-18; 450-20-25-7.

b. Items qualifying as *adjustments related to prior interim periods of the current fiscal year*, also defined in FASB ASC 250-10-45-25 and 45-26; 270-10-45-17 and 45-18; 450-20-25-7.

Prior Period Adjustments

FASB ASC 250-10-05-4; 250-10-20; and 250-10-45-22 through 45-24 limit the definition of prior period adjustments to the correction of an error.

Errors in financial statements, as defined in FASB ASC 250-10-20, include—

a. Mathematical mistakes.

b. Mistakes in the application of accounting principles.

c. Oversight or misuse of facts that existed at the time the financial statements were prepared.

A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error under the above definition. Because a change in accounting estimate results from new information or subsequent developments, it is usually distinguishable from an error and should not be reported as a prior period adjustment.

Examples

Application of this definition is illustrated in the following examples.

a. Situations qualifying for correction of errors in prior period statements include—

(1) When preparing the second-quarter financial statements, you discover that the list used to record accounts payable in the first-quarter financial statement was footed incorrectly by a material amount. This is obviously a mathematical error that should be reported as a prior period adjustment.

(2) You have obtained a new client, a contractor on the percentage-of-completion method. Your first task is to prepare reviewed statements for the first quarter. When inquiring about a substantial loss on a job completed in the quarter, you discover that the loss had been anticipated and was very close in amount to estimates made by management at the end of the prior fiscal year. You also learn that the projected loss was not recorded in the prior year statements. This represents a mistake in application of the percentage-of-completion method or an oversight of facts and thus qualifies as a prior period correction.

(3) When preparing the second-quarter financial statements of a new client, you discover that the statements for the previous quarter included income tax expense computed on income-to-date instead of being computed using an estimated annual effective rate. This represents an incorrect application of GAAP, and thus the first-quarter statements should be restated for the errors, if material, before preparing the second-quarter statements.

b. Examples of situations that do not qualify as errors in prior period statements:

(1) At the end of the first quarter, XYZ Company had pretax income of $20,000, the estimated taxable income for the year was $50,000, and the estimated annual effective tax rate was 15%. At the end of

the second quarter, the Company had pretax income of $70,000, and the estimated taxable income for the year was revised to $200,000, producing an estimated annual effective tax rate of 28%. Had the estimated effective tax rate been 28% at the end of the first quarter, the income tax would have been $5,600 instead of $3,000. The change in estimated effective tax rates is a change in accounting estimate, not an error, and thus the second-quarter income tax expense should include the entire effect of the rate change. The first quarter would not be restated to reflect the higher income tax expense.

(2) When preparing the second-quarter statements of the ABC Company, a contractor on the percentage-of-completion method, you determine that the expected profit on Job No. 207 is estimated to be $44,000 and that the job is estimated to be 50% completed at the end of the quarter. You therefore record $22,000 of profit on the job. The job is completed by the end of the third quarter with a total profit of $30,000. Had you correctly estimated the profit at the end of the second quarter, you would have recorded only $15,000 of profit in the second quarter rather than $22,000. This difference is a result of subsequent developments affecting the estimate and does not qualify as an error. Thus, the second-quarter statements are not restated.

Adjustments Related to Prior Interim Periods of the Current Fiscal Year

Prior Interim Period Adjustments That Are Not Errors. FASB ASC 250-10-45-25 and 45-26; 270-10-45-17 and 45-18; and 450-20-25-7 establish special situations that warrant correction of prior interim periods *that would not otherwise qualify as an error to be corrected in a prior period under the general rules for prior period adjustments*. Thus, treatment of these items in interim financial statements differs from the treatment they would receive in annual financial statements.

In summary, FASB ASC 250-10-45-25 and 45-26; 270-10-45-17 and 45-18 indicate that adjustment or settlement of the following items requires restatement of prior interim periods if the effect is material, can be identified with a specific prior interim period, and is now (but not previously) subject to estimation:

a. Litigation or similar claims.

b. Income taxes.

c. Renegotiation proceedings.

d. Utility revenue under rate-making processes.

Normal recurring corrections and adjustments that are the result of the use of estimates inherent in the accounting process, such as changes in the allowance for bad debts, are not considered to be prior period adjustments.

An adjustment caused by one of the occurrences listed above that occurs in an interim period should be accounted for as follows:

a. The portion related to the current interim period should be included in the determination of net income of the current period.

b. Prior interim periods should be restated to include the portion related to each interim period in the determination of net income of that period. The portion related to prior fiscal years should be included in the net income of the first interim period of the current fiscal year.

The following example illustrates application of these rules. However, the practitioner should consult FASB ASC 250-10; 270-10 when dealing with prior period adjustments.

> Approximately 30% of the sales of the XYZ Company are made in a neighboring state, and the Company has taken the position that it is not subject to that state's sales tax. In the third quarter, the controller of the neighboring state completed an audit of the last four fiscal years of the Company and assessed substantial additional sales taxes. The lawyer for the XYZ Company advised that the state will prevail if the assessment is challenged.

In preparing financial statements that present the third quarter results of operations and the year-to-date operations, the year-to-date operations should include as an expense the assessment for the prior years as well as for the accrual of similar taxes on sales for the first three quarters of this year. The third-quarter operations would include only the sales tax expense accrued on sales made in the third quarter.

In the interim period in which a prior period adjustment occurs, the *effects* on income from continuing operations and net income should be disclosed for each prior interim period of the current year. The restated income from continuing operations and net income of each prior interim period also should be disclosed.

Prior Interim Period Adjustments That Are Errors. In single period statements (month of June or second quarter), prior interim period adjustments of errors shall be reflected as adjustments to beginning retained earnings. When comparative statements are presented, the prior-period adjustments of errors should be applied retroactively for all prior periods presented. Net income and retained earnings balances should be restated for each interim period presented.

Materiality

A discussion of materiality in interim financial statements appears later in this lesson.

THE EFFECT OF ACCOUNTING CHANGES ON INTERIM FINANCIAL STATEMENTS

General

Accounting changes include changes in an accounting principle, changes in an accounting estimate, and changes in the reporting entity. The term does not include corrections of errors, which were discussed earlier in this lesson.

An in-depth discussion of each type of accounting change and how it is dealt with in annual statements is beyond the scope of this course. More information on that topic can be found in *PPC's Guide to Compilation and Review Engagements*. The following paragraphs focus on how these accounting changes affect interim financial statements.

Change in Accounting Estimate

The accounting treatment applicable to changes in accounting estimates in annual statements is equally applicable to interim statements. The effects of changes in estimates should be reported in the interim period of change and subsequent periods. Restatement of prior interim periods is not appropriate. Disclosure of a change in an accounting estimate is necessary if the change affects several future periods, such as a change in the useful lives of depreciable assets, or if the effect of change is material.

Change in Reporting Entity

The accounting treatment applicable to a change in reporting entity in annual statements applies also to interim statements.

Change in Accounting Principle

For purposes of interim financial statements, an accounting change has occurred if an accounting principle or the method of application of that principle is different from that used in the preceding interim period, the prior annual period, or the comparable interim period of the prior year.

FASB ASC 250-10-05-2 requires a change in accounting principle to be reported by retrospective application of the new principle to the financial statements of all prior periods, unless impracticable. However, for changes in an accounting principle made in an interim period, an entity is not allowed to apply the impracticability exception to prechange interim periods in the fiscal year in which the change is made. Therefore, if it is impracticable to retrospectively apply a new accounting principle to prechange interim periods, the change is required to be made as of the beginning of a subsequent fiscal year.

Disclosure of Change in Accounting Principle

The disclosures required in interim statements for a change in accounting principle are summarized as follows:

a. The nature and justification for the change should be disclosed in interim statements in which the new principle is adopted.

b. The method of applying the change, and—

    (1) A description of the prior-period information that has been retrospectively adjusted, if any.

    (2) The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item for the current period and any prior periods retrospectively adjusted. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.

    (3) The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.

c. If indirect effects of a change in accounting principle are recognized—

    (1) A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period.

    (2) Unless impracticable, the amount of the total recognized indirect effects of the accounting change that are attributable to each prior period presented.

d. In financial statements of subsequent (post-change) interim periods in the year of adoption, the effect of the change on income from continuing operations and net income for the post-change interim periods should be disclosed.

Materiality

Materiality for the purpose of reporting the effect of an accounting change or correction of an error should be based on estimated income for the full fiscal year and also on the effect on the trend of earnings. Changes that are material with respect to an interim period but not material with respect to the estimated income for the full fiscal year or to the trend of earnings should be separately disclosed in the interim period.

DISCLOSURE REQUIREMENTS FOR THE INTERIM FINANCIAL STATEMENTS OF NONPUBLIC ENTITIES

Disclosure requirements for interim financial statements of nonpublic entities are basically the same as for annual financial statements with the following exceptions:

a. Disclosure of accounting policies does not apply to unaudited interim statements unless an accounting policy has been changed (FASB ASC 235-10-50-2), as discussed in the previous section. (However, most accountants disclose accounting policies when interim statements include notes.)

b. For companies with material seasonal variations, the seasonal nature of their activities should be disclosed, and consideration should be given to supplementing interim reports with information for a 12-month period ending with the interim date (FASB ASC 270-10-45-11). For example:

NOTE A—SEASONAL FLUCTUATIONS

The Company's primary business is the operation of an amusement park from May 1 to September 30 each year. The Company generally derives 90% of its revenue during this period. The current financial statements for the three months ended March 31, 20X1, therefore, reflect results of operations during part of the Company's off-season, during which it incurs expenses in preparation for its operating season.

c. Use of the gross profit method of interim inventory pricing should be disclosed. Significant adjustments to reconcile to the annual physical inventory should also be disclosed (FASB ASC 270-10-45-6). An example was provided earlier in this lesson.

d. Other unusual methods of accounting for interim inventories such as LIFO estimations should be disclosed. An example was provided earlier in this lesson.

e. Generally, disclosure should be made as to the nature and amount of material costs or expenses incurred in an interim period that cannot be readily identified with the activities or benefits of other interim periods (FASB ASC 270-10-45-8). These disclosures can generally be made on the face of the income statement by providing an appropriate descriptive title to the cost or expense shown as a single line item.

f. If any accounting principle used in an interim financial statement differs from that applied in—

   (1) the preceding interim period,

   (2) the prior annual financial statements, or

   (3) the comparable interim period of the prior year,

   disclosure of the change is required in the interim financial statements (FASB ASC 270-10-45-12). A more complete discussion of accounting changes in interim financial statements was provided earlier in this lesson.

g. The gross and net of tax effects of prior period adjustments on net income should be disclosed in the interim period in which the adjustments are made. A more complete discussion of prior period adjustments was provided earlier in this lesson.

h. When adjustments related to prior interim periods of the current fiscal year are made, (1) the effect on income from continuing operations and net income for each prior interim period and (2) restated income from continuing operations and net income of each prior interim period should be disclosed.

REPORTING REQUIREMENTS

The reporting requirements are determined based on the service for which the accountant has been engaged. If the accountant is engaged to prepare the interim financial statements, there are no reporting requirements. Requirements for financial statement preparation engagements are found in AR-C 70. If the accountant is engaged to compile the interim financial statements, the reporting requirements of AR-C 80 apply. If the accountant is engaged to review the interim financial statements, the reporting requirements of AR-C 90 apply.

An in-depth discussion of each of these AR-C sections is beyond the scope of this course. More information is available in *PPC's Guide to Compilation and Review Engagements*. The following paragraphs discuss particular reporting issues that affect interim financial statements.

Use of Different Bases of Accounting at Interim and Annual Periods

As discussed earlier in this lesson, the SSARS imply that a nonpublic entity is permitted to use a special purpose framework for preparing its interim financial statements and generally accepted accounting principles (GAAP) for preparing its annual statements. As long as the basis of accounting and how it differs from GAAP is adequately disclosed in the interim financial statements, accountants should issue the appropriate compilation or review report on the special purpose interim financial statements. Accountants also should issue a standard compilation or review report on the annual GAAP financial statements. The annual GAAP financial statements and the related accountant's report need not mention that the separately issued interim financial statements were prepared using a different basis of accounting.

Reporting on Financial Statements Prepared in Accordance with a Special Purpose Framework

As previously discussed, interim financial statements are often prepared in conformity with a special purpose framework such as the cash or tax basis of accounting. The accountant's compilation or review report on any financial statements, interim or otherwise, prepared in accordance with a special purpose framework should include a separate paragraph that (AR-C 80.21 and AR-C 90.43):

- Names the special purpose framework used to prepare the financial statements.
- Refers to the note in the financial statements that describes the special purpose framework that was used (if notes are included).
- States that the special purpose framework is a basis of accounting other than GAAP.

Additionally, the accountant's report should state that it is management's responsibility to determine that the financial reporting framework is appropriate if management has a choice of which framework to use to prepare the financial statements. Lesson 2 discusses financial statements prepared in accordance with a special purpose framework.

Change in the Basis of Accounting

Lesson 2 addresses reporting when a company changes its basis of accounting (for example, from GAAP to a special purpose framework) from that used in a prior year. It seems logical that the same guidance would apply when an entity changes the basis of accounting it uses from one interim period to the next. In summary, they believe that:

- It is preferable, for comparative purposes, to restate any prior interim periods presented to the new basis of accounting adopted by the company.
- Accountants are not required (but are permitted) to add a paragraph highlighting the change in basis to their compilation or review reports. (The change in basis should be adequately disclosed in the interim financial statements.)

Special Considerations for Twelfth-month Interim Statements When a Higher Level of Service Will Be Performed

Frequently, companies issue interim statements that omit (a) substantially all disclosures and (b) accruals for items such as taxes, bonuses, depreciation, etc. Sometimes, the interim statements might even be prepared using a special purpose framework. At year-end, however, management wants full-disclosure compiled, reviewed, or audited GAAP statements. Anxious about year-end results, the client generally wants the twelfth-month statements as soon as possible, but considerable work might be necessary to issue even a compilation report on the full-disclosure, year-end GAAP statements. How can accountants satisfy their clients and still ensure they have time to perform necessary procedures required by professional standards? It is a best practice for accountants who find themselves in that position to stamp the twelfth-month statements "Draft" and follow up with final audited, reviewed, or compiled statements after the year-end work is complete.

Using Standardized Reports

Using standardized reports is often possible in recurring interim engagements because interim financial statements tend to be consistent from one period to the next. For example, a client that chooses to omit disclosures and not record certain accruals in compiled financial statements will tend to do so for all interim compiled financial statements. The use of standardized reports is desirable because it allows the accountant to be more efficient.

One common method of standardizing reports is to refer to "the periods then ended" rather than to the specific periods covered. For example, a report on financial statements covering the one month and nine months ended September 30, 20XX, might refer to the "balance sheet of XYZ Company as of September 30, 20XX, and the related statement of income and retained earnings *for the periods then ended*." While this is not technically correct, it may be a practical necessity, particularly if the accountant is using a software package that is set up this way and cannot be easily modified. Such a report would probably not be misleading as long as the related statements of income and retained earnings (and, if included, cash flows) specify the periods covered in the financial statements' headings.

SELF-STUDY QUIZ

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

10. All of the following would be reported as a *prior period adjustment* in interim financial statements **except**:

    a. A mathematical mistake.

    b. A mistake in how an accounting principle was applied.

    c. A change in accounting estimate.

    d. Facts misused when the financial statements were prepared.

11. Prior period interim financial statements will be affected by which of the following?

    a. Material litigation settlements newly identified with a prior period.

    b. Routine, recurring adjustments due to changes in the allowance for bad debts.

    c. The change of an accounting estimate.

    d. An immaterial adjustment to income taxes.

SELF-STUDY ANSWERS

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

10. All of the following would be reported as a *prior period adjustment* in interim financial statements **except**: **(Page 286)**

    a. A mathematical mistake. [This answer is incorrect. Mathematical mistakes are considered *errors* under FASB ASC 250-10-20; therefore, they are included in the definition of a prior period adjustment.]

    b. A mistake in how an accounting principle was applied. [This answer is incorrect. According to FASB ASC 250-10-20, mistakes in the application of accounting principles are considered *errors*, which means they would be reported as a prior period adjustment.]

    c. A change in accounting estimate. [This answer is correct. FASB ASC 250 limits the definition of prior period adjustments to the correction of errors. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error under the above definition. However, because a change in accounting estimate results from new information or subsequent developments, it is usually distinguishable from an error and should *not* be reported as a prior period adjustment.]

    d. Facts misused when the financial statements were prepared. [This answer is incorrect. Per FASB ASC 250-10-20, the oversight or misuse of facts that existed at the time the financial statements were prepared is considered an *error*. Because of this classification as an error, this would be considered a prior period adjustment.]

11. Prior period interim financial statements will be affected by which of the following? **(Page 287)**

    a. Material litigation settlements newly identified with a prior period. [This answer is correct. FASB ASC 250 and 270 indicate that adjustment or settlement of the following items requires restatement of prior interim periods if the effect is material, can be identified with a specific prior interim period, and is now (but not previously) subject to estimation: (1) litigation or similar claims, (2) income taxes, (3) renegotiation proceedings, and (4) utility revenue under rate-making processes.]

    b. Routine, recurring adjustments due to changes in the allowance for bad debts. [This answer is incorrect. Normal recurring corrections and adjustments that are the result of the use of estimates inherent in the accounting process, such as changes in the allowance for bad debts, are not considered to be prior period adjustments.]

    c. The change of an accounting estimate. [This answer is incorrect. The effects of changes in estimates should be reported in the interim period of change and subsequent periods. Restatement of prior interim periods is not appropriate.]

    d. An immaterial adjustment to income taxes. [This answer is incorrect. Because this adjustment is not material, it would not require restatement of prior periods under FASB ASC 250 and 270.]

Lesson 2: Financial Statements Presented in Accordance with a Special Purpose Framework

INTRODUCTION

Unaudited financial statements of nonpublic companies prepared in accordance with a special purpose framework are clearly governed by SSARS.

The term *special purpose framework* is included in the definition sections of AR-C 70, AR-C 80, and AR-C 90 and is described as a financial reporting framework other than GAAP, that is one of the following bases of accounting:

a. *Cash Basis.* A basis of accounting that the entity uses to record cash receipts and disbursements, including modifications of the basis that have substantial support (such as recording fixed asset depreciation).

b. *Tax Basis.* A basis of accounting used by an entity to file its tax return for the period covered by the financial statements.

c. *Regulatory Basis.* A basis of accounting that the entity uses to comply with the requirements (or financial reporting provisions) of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies follow that is prescribed or permitted by a state insurance commission).

d. *Contractual Basis.* A basis of accounting used by an entity to comply with an agreement between the entity and one or more third parties other than the accountant.

e. *Other Basis.* A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material financial statement items.

AR-C 70.07, AR-C 80.05, and AR-C 90.05 indicate that the term *OCBOA* is commonly used to refer to the cash basis, tax basis, regulatory basis, and other basis of accounting.

This course primarily discusses special purpose financial statements prepared on the tax and cash bases, with limited information on the regulatory and contractual bases. A discussion of financial statements presented on a regulatory or contractual basis is beyond the scope of this course, but more information is available in *PPC's Guide to Compilation and Review Engagements*.

This course does not address issues related to financial statements prepared in accordance with International Financial Reporting Standards.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the different types of special purpose frameworks, how they fit in with the accounting standards, when to use a special purpose framework, and how different bases of accounting are used.
- Recognize the statement titles that are appropriate under the cash and tax basis, how various financial statements will be affected if a special purpose framework is used; applicable presentation considerations; and how to deal with disclosures, cash to accrual conversions, engagement and representation letters, and reporting issues.

SPECIAL PURPOSE FRAMEWORKS AND THE ACCOUNTING STANDARDS

Authoritative Literature

The SSARS provide the following guidance on special purpose frameworks:

- The definition of the term *special purpose framework*.
- Specific requirements for preparing financial statements when they are prepared using a special purpose framework.
- Management's acknowledgment of its responsibilities if the financial statements are prepared using a special purpose framework for compilation and review engagements.
- The accountant's responsibility to modify the compilation or review report when financial statements prepared using a special purpose framework do not include required disclosures.
- Additional requirements for compilation and review reports when financial statements are prepared using a special purpose framework.
- Illustrative engagement letters for compilation and review engagements of financial statements prepared using a special purpose framework.
- Illustrative reports for compilation and review engagements of financial statements prepared using a special purpose framework.

AU-C 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, provides certain additional guidance on the subject. When the SSARS provides guidance, this lesson refers to that guidance. When the SSARS is silent on a situation related to special purpose financial statements, the current practice is to look to AU-C 800 for guidance and to consider that guidance in the context of compiled or reviewed financial statements. In situations when the SSARS and AU-C 800 both provide guidance that is not basically identical, then both are discussed.

AICPA Financial Reporting Framework for Small- and Medium-sized Entities

The AICPA's *Financial Reporting Framework for Small- and Medium-Sized Entities* (*FRF for SMEs*™ or Framework) is an optional reporting framework that provides another GAAP-alternative for small businesses. However, unlike the other common GAAP-alternative (or special purpose) frameworks, the FRF for SMEs accounts for an entity's transactions according to their economic substance, which is the same objective as GAAP. While historical cost is the primary measurement basis, there are also some similarities to the tax basis. For certain accounting policies, the Framework allows alternatives so that an individual business can select the policy they believe best meets the needs of the users of their financial statements.

The FRF for SMEs is not authoritative, so it has not been acted upon, approved, or disapproved by any senior technical committee of the AICPA or FASB. It has no effective date and the AICPA cannot require its use. Small- and medium-sized entities can choose to adopt it at any time. Practitioners can report on compiled, reviewed, or audited financial statements prepared using the Framework because it meets the definition of a special purpose framework described in section . The FRF for SMEs fits the *other basis* type of special purpose framework.

Definition of a SME. The Framework does not define *small- and medium-sized entity*, and has no size thresholds that must be met for an entity to be considered an SME. However, it provides a list of characteristics that indicate an entity could be an SME, although the list is not all-inclusive and the criteria listed are not required to be met. According to the Framework, the following are characteristics of an SME:

- The entity is not required to prepare GAAP-based financial statements.
- The entity has no plans to go public in the foreseeable future.

- The entity is a for-profit entity.
- The owner(s) of the entity is also the person(s) who runs the entity.
- There is no highly-specialized accounting guidance for the industry in which the entity operates.
- There are no overly complicated transactions.
- There are no significant foreign operations.
- The financial statement users have direct access to management.

While one of the previous characteristics mentions that the entity is a for-profit entity, this course suggests that some nonprofit organizations could be eligible to use the Framework. For example, nonprofits that are not affected by specialized guidance on contributions and net asset classifications may find this to be an appropriate framework.

Major Differences from GAAP. While much of the guidance in the FRF for SMEs is similar to guidance under GAAP, there are also many differences. Some of the areas that seem to have the most significant differences include—

- Accounting for income taxes.
- Accounting for intangible assets acquired in a business combination.
- Amortization of goodwill.
- Reporting of subsidiaries.
- Accounting for and reporting of VIEs.
- Accounting for leases.
- Accounting for stock-based compensation.
- Accounting for defined benefit plans.
- Impairment of assets.
- Recurring adjustment for changes in the value of debt and equity investments.

Additional Information. Additional information about the Framework is available on the AICPA's website, including a free PDF document of the framework available for download, a listing of frequently asked questions and answers, three different FRF for SMEs toolkits, an accounting framework decision tool, and more, all at **www.aicpa.org/FRF-SMEs**.

PPC Guide. *PPC's Guide to the Financial Reporting Framework for Small- and Medium-Sized Entities* provides detailed information on preparing financial statements based on the FRF for SMEs. That *Guide* includes a disclosure checklist, highlights differences between GAAP and the Framework, illustrates how to convert GAAP-basis financial statements to the Framework, helps accountants explain the Framework to clients and financial statement users, and much more. The *Guide* can be ordered by calling (800) 431-9025 or at **tax.thomsonreuters.com**.

DECIDING WHEN USE OF A SPECIAL PURPOSE FRAMEWORK IS APPROPRIATE

The basis that a company uses to prepare its financial statements generally is determined by the needs of those who will use the financial statements. Companies reporting financial results to third parties often use GAAP for financial statements. The use of GAAP in such circumstances promotes comparability among financial statements and, because users become familiar with GAAP through experience with it, its general use increases user understanding.

There are, however, instances when a company may choose to present special purpose financial statements; for example, when—

a. Third-party use of the financial statements is limited to a few creditors who do not require GAAP.

b. The operations are heavily influenced by:

(1) Cash flow (for example, professional corporations of doctors typically distribute all cash basis earnings through salary, bonuses, and retirement plan contributions), and

(2) Tax implications (for example, partners in some partnerships are primarily interested in the tax treatment of transactions because of the ultimate effect on their personal tax returns).

Cash and Modified Cash Bases

In practice, use of the pure cash basis is generally limited to entities with very simple operations. Entities that might use the pure cash basis of accounting include small brokers, small manufacturer representatives, school activity funds, fairs and other civic ventures, trusts and estates, political action committees, and political campaigns.

Use of the modified cash basis is more common. To help provide some consistency in its use, however, it is a best practice to limit it to entities whose operations are—

a. oriented toward cash receipts and disbursements,

b. not significantly influenced by financing of sales or purchases, and

c. relatively simple and do not have complexities (such as manufacturing, development, or other conversion activities or common acquisitions of property and equipment) that require significant modifications.

Tax Basis

Companies that use the tax basis of accounting are typically either profit-oriented enterprises (such as small, closely held companies) for which the cost of conversion to GAAP would exceed the benefit, or partnerships whose partnership agreements require use of the tax basis of accounting.

IDENTIFYING THE BASIS OF ACCOUNTING

The following discussion is intended to present simple rules of thumb for identifying the basis of accounting used.

Cash or Modified Cash Basis

The cash basis of accounting, in its pure form, recognizes revenues and expenses based on the receipt and disbursement of cash. The pure cash basis treats all disbursements of cash as expenses; thus, the purchase of property and equipment or inventory is recognized as an expense rather than as an asset. Stated another way, under the pure cash basis of accounting, the balance sheet contains only cash and equity, and the income statement reflects all cash receipts as revenues and all cash disbursements as expenses.

Modification of the cash basis should have *substantial support*. A modification would usually have "substantial support" if the modification is equivalent to GAAP for the particular item and if the modifications taken together are not illogical. An example of modifications taken together that are illogical would be recording revenue on the accrual basis and recording purchases and other costs on the cash basis.

A modification of the cash basis of accounting to record depreciation on property and equipment is noted in AR-C 70.07, AR-C 80.05, and AR-C 90.05 as having substantial support. If modifications to the cash basis of accounting do not have substantial support, the accountant should appropriately modify his or her report.

Examples of modifications recognized as having substantial support in practice are recording—

a. Property and equipment purchased as assets.

b. Accumulated depreciation.

c. Material amounts of inventory purchased for cash as assets.

d. Liabilities arising from the receipt of borrowed cash.

e. Employee FICA and withholding taxes that have not been deposited with the IRS but relate to compensation paid.

f. Accrued income taxes.

If the cash basis statement has so many modifications that it is in substance a GAAP basis statement, it should be reported on as such. The accountant should use the standard form of report, modified as appropriate because of departures from generally accepted accounting principles.

Some accountants prefer identifying cash basis financial statements with modifications as *modified cash basis* financial statements. Others prefer the term *cash basis*. Whichever term is used, the financial statements should be appropriately titled and the accountant's compilation or review report should refer to the titles used.

The modified cash basis, while widely used in the profession, is not viewed by many as the financial reporting framework that offers the best solution to the standards overload problems of GAAP. One reason is the difficulty of identifying which modifications of the cash basis are appropriate in the circumstances and which are departures from the cash basis. A frequently mentioned alternative to GAAP that presently has more appeal is the tax basis of accounting.

Tax Basis

Some entities maintain their accounting records on a basis identical to, or substantially identical to, that needed to file their tax returns. When financial statements are prepared from such records, a determination of the proper description of the basis of accounting used can become a confusing issue. For example, the basis of accounting allowed by tax law could range from GAAP to the cash basis. Between these two options, tax law may also allow special accounting treatments that conform neither to GAAP nor cash basis accounting principles.

If the basis of accounting used to file the tax return is accrual, the additional cost of preparing GAAP financial statements may be minimal. (As noted later in this lesson, special purpose framework and GAAP disclosures are very similar.) In that set of facts and circumstances, it is normally preferable to describe and report on such financial statements as GAAP. However, this general advice is not appropriate if an agreement, e.g., a partnership agreement, specifically calls for use of the tax basis because (a) it is confusing to the users of the financial statements to refer to the statements as GAAP when they expect the tax basis (even if the two are the same) and (b) in future years, the entity may elect a tax accounting treatment that would be materially different from GAAP, resulting in a confusing accountant's report.

When the accrual basis of accounting used to file the tax return contains a tax election that is not appropriate for GAAP financial statements, and the cost of converting to GAAP exceeds the benefits, the financial statements should normally be identified and reported on as tax basis. Examples of such tax elections are—

a. Depreciation computed in accordance with the Accelerated Cost Recovery System (ACRS) and the Modified Cost Recovery System (MACRS) resulting in material differences from depreciation computed on estimated useful lives.

b. Deduction of statutory depletion.

c. Deduction of intangible development costs on producing wells.

d. Use of property valuations allowed for tax purposes that differ materially from historical cost (e.g., stepped-up basis).

e. Accounting for investments in other entities that would be required to be consolidated or carried on the equity basis in GAAP financial statements at cost.

Presentation of Income Taxes. Ordinarily, users of financial statements prepared on the tax basis are interested primarily in the tax effect of earnings. Accordingly, it is a best practice for C corporations using the tax basis to measure and accrue income taxes based on taxable earnings, even when the cash method is used for tax reporting purposes. (Failure to include an income tax provision when preparing tax basis financial statements could be a departure from the tax basis of accounting.) Estimates may be necessary, such as when the financial statements are prepared before the state or federal income tax returns are prepared.

USING DIFFERENT BASES OF ACCOUNTING

Change in Basis of Accounting

Sometimes, an entity may change its basis of accounting from that used in prior years to prepare its financial statements. For example, it may decide to change from using a special purpose framework, such as the cash or tax basis, to generally accepted accounting principles to prepare its statements or vice-versa.

FASB ASC 250-10 provides guidance on measurement and disclosure of an accounting change, which FASB ASC 250-10-20 refers to as one of the following: a *change in an accounting principle*, a change in an accounting estimate, or a change in the reporting entity. FASB ASC 250-10-20 indicates that a change in an accounting principle results when an entity changes from one generally accepted accounting principle to a different generally accepted accounting principle when two or more generally accepted accounting principles could apply or when the accounting principle previously used is no longer generally accepted.

The guidance in FASB ASC 250-10 was, therefore, designed to address a change within one financial reporting framework—accounting principles generally accepted in the United States of America. It was not designed to address a change from one financial reporting framework to another financial reporting framework. For example, it was not designed to address a change from the tax basis of accounting to accounting principles generally accepted in the United States of America or vice versa. As a practical matter, accounting literature does not address financial reporting frameworks other than accounting principles generally accepted in the United States of America.

Nevertheless, nonauthoritative Q&A 9030.10 states that when a change in accounting basis occurs, it should be disclosed in the notes to the financial statements. This course's recommendation differs from that expressed in the Q&A because FASB ASC 250-10 does not apply to a change in a special purpose framework (which Q&A 9030.10 acknowledges). Accordingly, such guidance does not have to be considered in special purpose financial statements. However, depending on the facts and circumstances, disclosure of the change in accounting basis may be helpful to users of the financial statements.

Finally, while not required, accountants may add an emphasis-of-matter paragraph to their compilation or review report on special purpose financial statements to highlight a change in the basis of accounting. If accountants decide to add an emphasis-of-matter paragraph to their report, Q&A 9030.10 provides illustrative language they may use. The SSARS specifically allow, and sometimes require, emphasis-of-matter and other-matter paragraphs to be included in the accountant's review report. Also, such paragraphs may be included in the accountant's compilation at the accountant's discretion.

Use of Different Bases of Accounting for Financial Statements of the Same Period

Companies may request that accountants compile or review financial statements prepared using a special purpose framework when the accountants have previously compiled or reviewed GAAP financial statements for the same period. For example, a regulatory agency might require that a company use the accounting basis it uses for preparing its federal income tax returns to prepare financial statements it submits to the agency, while a bank may request GAAP financial statements for the same period of time. Accountants sometimes question whether they should or may add an emphasis-of-matter paragraph to their report on the special purpose financial statements to highlight that both GAAP and special purpose financial statements exist for the same period of time. However, the SSARS do not address this issue. Consequently, it seems logical that accountants are permitted (but not required) to add such a paragraph to their compilation or review reports.

SELF-STUDY QUIZ

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

12. What special purpose framework is used to comply with an agreement between the entity providing the financial statements and at least one third party?

    a. Cash basis.

    b. Contractual basis.

    c. Regulatory basis.

    d. Tax basis.

13. Which of the following entities would most likely be considered a *small- and medium-sized entity* (SME) under the AICPA's *Financial Reporting Framework for Small- and Medium-Sized Entities* (FRF for SMEs)?

    a. Amigos United has regular operations in Mexico.

    b. The users of Cornerstone's financial statements do not have direct access to management.

    c. Medding Enterprises is required to prepare GAAP financial statements.

    d. Alston Electronics is run by the same individuals who own it.

SELF-STUDY ANSWERS

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

12. What special purpose framework is used to comply with an agreement between the entity providing the financial statements and at least one third party? **(Page 295)**

    a. Cash basis. [This answer is incorrect. According to the definition sections of AR-C 70, AR-C 80, and AR-C 90, the *cash basis* is a basis of accounting that the entity uses to record cash receipts and disbursements, including modifications of the basis that have substantial support (such as recording fixed asset depreciation). Agreements as described above are not included in this definition.]

    b. Contractual basis. [This answer is correct. The term *special purpose framework* is included in the definition sections of AR-C 70, AR-C 80, and AR-C 90 and is described as a financial reporting framework other than GAAP that is one of several specific bases of accounting, including the contractual basis. The *contractual basis* is a basis of accounting used by an entity to comply with an agreement between the entity and one or more third parties other than the accountant.]

    c. Regulatory basis. [This answer is incorrect. The *regulatory basis* is a basis of accounting that the entity uses to comply with the requirements (or financial reporting provisions) of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies follow that is prescribed or permitted by a state insurance commission). Third-party agreements, as described above, are not part of this basis, as it is described in AR-C 70, AR-C 80, and AR-C 90.]

    d. Tax basis. [This answer is incorrect. The *tax basis* is a basis of accounting used by an entity to file its tax return for the period covered by the financial statements. Therefore, it is not related to the type of agreements described above, per this definition provided in AR-C 70, AR-C 80, and AR-C 90.]

13. Which of the following entities would most likely be considered a *small- and medium-sized entity* (SME) under the AICPA's *Financial Reporting Framework for Small- and Medium-Sized Entities* (FRF for SMEs)? **(Page 296)**

    a. Amigos United has regular operations in Mexico. [This answer is incorrect. Based on the guidance in the FRF for SMEs, having *no* significant foreign operation is a typical characteristic of an SME. Because Amigos United has operations outside of the U.S., it is less likely to be given SME status.]

    b. The users of Cornerstone's financial statements do not have direct access to management. [This answer is incorrect. Per the FRF for SMEs, one of the characteristics that could indicate an entity is an SME is when the financial statement users have direct access to the entity's management. Since that is *not* the case for Cornerstone, this entity is less likely to fall into the SME classification.]

    c. Medding Enterprises is required to prepare GAAP financial statements. [This answer is incorrect. According to the FRF for SMEs, *not* being required to prepare GAAP-based financial statement is a characteristic of an SME. Therefore, since Medding Enterprises is required to present GAAP statements, it is less likely to be considered an SME.]

    d. Alston Electronics is run by the same individuals who own it. [This answer is correct. The FRF for SMEs does not define SME and has no size thresholds that must be met for an entity to be considered an SME. However, it provides a list of characteristics that indicate an entity *could* be an SME, although the list is not all-inclusive and the criteria listed are not required to be met. One such characteristic provided by the FRF for SMEs is that the owner (or owners) of the entity is the person who runs the entity. Because this is the case for Alston Electronics, it is more likely that this business is an SME.]

STATEMENT TITLES USED FOR CASH AND TAX BASIS FINANCIAL STATEMENTS

AR-C 80.A28 and AR-C 90.A81 indicate that because cash basis and tax basis statements do not purport to present financial position and results of operations in accordance with GAAP, they ought not be titled or otherwise referred to as "Balance Sheet," "Income Statement," etc., without appropriate modification. This guidance would also hold true for prepared financial statements. The following are examples of acceptable special purpose financial statement titles:

- Balance sheet—cash basis
- Statement of assets and liabilities arising from cash transactions
- Statement of assets, liabilities, and stockholders' equity—tax basis
- Statement of revenue collected and expenses paid
- Statement of revenue and expenses—tax basis
- Statement of operations—tax basis

The understandability of special purpose presentations can be enhanced by the consistent use of uniform statement titles. Thus, the titles used in this course are the same for cash basis and tax basis financial statements except for the modifier "cash basis" or "tax basis." Exhibit 2-1 summarizes this course's recommendations for special purpose financial statement titles.

Exhibit 2-1

Recommended Special Purpose Statement Titles[a, b]

GAAP	Cash[c]	Tax
1. Balance Sheet	1. Statement of Assets, Liabilities, and Equity (Capital)—Cash Basis	1. Statement of Assets, Liabilities, and Equity (Capital)—Tax Basis
2. Statement of Income	2. Statement of Revenues and Expenses—Cash Basis	2. Statement of Revenues and Expenses—Tax Basis
3. Statement of Income and Retained Earnings	3. Statement of Revenues, Expenses, and Retained Earnings (Partners' Capital, Proprietor's Capital)—Cash Basis	3. Statement of Revenues, Expenses, and Retained Earnings (Partners' Capital, Proprietor's Capital)—Tax Basis
4. Statement of Retained Earnings	4. Statement of Retained Earnings—Cash Basis	4. Statement of Retained Earnings—Tax Basis
5. Statement of Changes in Stockholders' Equity	5. Statement of Changes in Stockholders' Equity (Partners' Capital, Proprietor's Capital)—Cash Basis	5. Statement of Changes in Stockholders' Equity (Partners' Capital, Proprietor's Capital)—Tax Basis
6. Statement of Cash Flows	7. Statement of Cash Flows—Cash Basis[d]	8. Statement of Cash Flows—Tax Basis[d]

Notes:

[a] These statement titles are recommended by this course. They seem to be acceptable under the SSARS. Other equally suitable titles can be derived from the suggested titles.

[b] These statement titles may not be appropriate for governmental or nonprofit organizations. See relevant AICPA Audit and Accounting Guides.

[c] The pure cash basis has a single asset and no liabilities. Accordingly, there is no need to present a balance sheet. Instead, a single statement titled "Statement of Cash Receipts and Disbursements" is ordinarily presented.

[d] Although a statement of cash flows for special purpose financial statements is not required, if it is presented, this course recommends that it be titled "Statement of Cash Flows—Cash (or Tax) Basis."

* * *

THE STATEMENT OF CASH FLOWS

AU-C 800, Appendix B, *Fair Presentation and Adequate Disclosure*, (AU-C 800.A34) states that special purpose financial statements may not include a statement of cash flows. If a presentation of cash receipts and disbursements is presented in a format similar to a statement of cash flows or if the entity chooses to present such a statement, the statement would either conform to the requirements for a GAAP presentation or communicate its substance. As an example, the statement of cash flows might disclose noncash acquisitions through captions on its face. If the statement is presented, the accountant would report on the statement as a basic financial statement.

THE STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

FASB ASC 505-10-50-2 requires disclosure of changes in components of stockholders' equity other than retained earnings when both financial position and results of operations are presented. AR-C 80.18, AR-C 80.A31, AR-C 90.40, and AR-C 90.A83 state that, when special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, the special purpose financial statements should include informative disclosures similar to those required by GAAP. Accordingly, it seems reasonable that special purpose financial statements that present both financial position and results of operations should disclose changes in the components of stockholders' equity.

THE STATEMENT OF RETAINED EARNINGS

Under GAAP, changes in retained earnings are required to be disclosed whenever results of operations are presented. Based on AR-C 80.18, AR-C 80.A31, AR-C 90.40, and AR-C 90.A83), it is a best practice for special purpose statements to also disclose the changes in retained earnings whenever results of operations are presented.

Changes in retained earnings generally are disclosed by one of the following methods:

a. *Presentation in the Stockholders' Equity Section of the Statement of Assets, Liabilities, and Equity.* Even though it is permitted, disclosing changes in retained earnings on the statement of assets, liabilities, and equity is not commonly found in practice except in certain computer-prepared financial statements. While that presentation sufficiently discloses changes in retained earnings when net income is the only change, it can be unwieldy and confusing when there are numerous changes.

b. *A Combined Statement of Income and Retained Earnings.* Disclosing changes in retained earnings in a combined statement of income and retained earnings is the method most frequently used in practice and is recommended by this course. In that presentation, the statement of retained earnings is presented as a continuation of the statement of revenues and expenses. Net income is followed in the statement by the retained earnings balance at the beginning of the period and the items that affected retained earnings during the period, which are totaled to arrive at the retained earnings balance at the end of the period. When used for special purpose financial statements, the statement generally should be titled, for example, "Statement of Revenues, Expenses, and Retained Earnings—Tax Basis."

   The combined format is especially efficient to use when there are relatively few changes to retained earnings and when the changes are simple in nature. However, when the changes are numerous or complex, the combined format has a tendency to become confusing and difficult to present. In those circumstances, it may be preferable to present a separate statement of retained earnings. (Another alternative would be to use the combined statement of income and retained earnings supplemented by a note disclosing information that would otherwise clutter the statement.)

c. *A Separate Statement of Retained Earnings.* When a separate statement of retained earnings is presented, it usually begins with the balance of retained earnings at the beginning of the period and then lists changes during the period, which are totaled to arrive at the balance at the end of the period.

d. *Notes to the Financial Statements.*

REQUIREMENTS FOR COMPREHENSIVE INCOME

FASB ASC 220-10-15-2 requires comprehensive income and its components to be reported when an entity presents a full set of financial statements that report financial position, results of operations, and cash flows unless the entity has no items of other comprehensive income in and period presented (FASB ASC 220-10-15-3). Comprehensive income includes both net income and other comprehensive income (i.e., capital revenues, expenses, gains, and losses that are reported as separate components of stockholders' equity rather than in net income). If a statement of cash flows is not presented, best practice indicates that reporting comprehensive income is not required.

FASB ASC 220-10-45-10A, lists components of other comprehensive income as including (not all inclusive):

- Unrealized gains and losses on debt and equity securities classified as available-for-sale.
- Certain amounts related to classifying debt securities as available-for-sale or held-to-maturity.
- Certain transactions related to pension or other postretirement benefits.
- Certain amounts related to foreign currency translation transactions.

The components of other comprehensive income generally do not occur in tax or pure cash basis financial statements and rarely, if ever, occur in modified cash or regulatory basis financial statements. Therefore, even if an entity presents a complete set of special purpose financial statements that include a statement of cash flows, it seems likely that the requirement to disclose comprehensive income typically will not apply.

CONSIDERATIONS RELATED TO FINANCIAL STATEMENT PRESENTATION

Captions within Special Purpose Financial Statements

Some practitioners do not use "net income," "retained earnings," etc., as captions within special purpose financial statements. Instead, captions such as "excess of revenues collected over expenses paid," "accumulated excess revenues over expenses paid," etc., are used. The SSARS indicate that special purpose financial statement *titles* ought to differ from GAAP financial statement titles. However, the SSARS are silent as to whether different *captions* ought to be used. AU-C 800 is also silent on this topic. As such, there is no stipulation to modify GAAP captions for inclusion in a special purpose presentation. Accountants may modify captions if they desire, however. Technical Questions and Answers Section 1500, *Financial Statements Prepared in Accordance With a Special Purpose Framework*, provides the following examples of modified captions (Q&A 1500.04):

Cash Basis

- Excess of Revenue Collected over Expenses Paid
- Excess of Expenses Paid over Revenue Collected
- Accumulated Excess of Revenue over Expenses Paid

Tax Basis

- Retained Earnings—Tax Basis
- Net Income—Tax Basis

Nontaxable Revenues and Nondeductible Expenses in Tax Basis Financial Statements

Certain revenues and expenses are not recognized under federal income tax laws. An example of such an item would be interest income on state and local government obligations. Many practitioners have questioned how to present these nontaxable revenues and nondeductible expenses when preparing tax basis financial statements. Although there is no authoritative guidance on this issue, it would be a best practice to use one of the following alternatives:

- Present the nontaxable revenues and nondeductible expenses as separate line items on a statement of revenues and expenses that does not reconcile to taxable net income (e.g., a separate financial statement line item might be captioned, "tax-free interest income on state and local government obligations").
- Include the nontaxable revenues and nondeductible expenses in line items with taxable revenues and deductible expenses (such as interest income and other expenses), but then provide a reconciliation on the statement of revenues and expenses or in the notes that starts with pretax income and lists permanent differences to arrive at taxable income.

DISCLOSING THE BASIS OF ACCOUNTING

AR-C 80.18 and AR-C 90.40 indicate that the accountant should modify his or her report when the special purpose financial statements do not include a description of the special purpose framework, a summary of significant accounting policies, or an adequate description of how the special purpose framework differs from GAAP (excluding the exception provided for compiled financial statements that omit substantially all disclosures as discussed later in this lesson). A note in the financial statements disclosing the basis of accounting might read as follows:

> NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
>
> <u>Basis of Accounting</u>
>
> The Company's policy is to prepare its financial statements on the cash basis of accounting; consequently, certain revenues are recognized when received rather than when earned, and certain expenses and purchases of assets are recognized when cash is disbursed rather than when the obligation is incurred.

Compiled Special Purpose Financial Statements that Omit Substantially All Disclosures

When reporting on compiled financial statements prepared using a special purpose framework, AR-C 80.21 requires, among other things, that the accountant's report refer to a note included in the financial statements that describes the framework. However, when compiled special purpose financial statements omit substantially all disclosures and the omission is not, to the accountant's knowledge, undertaken with the intent of misleading users of the financial statements, referring to a note that describes the special purpose framework would not be applicable. AR-C 80.A29 indicates that such financial statements need not include a summary of significant accounting policies, nor a description about how the special purpose framework differs from GAAP.

OTHER DISCLOSURES THAT MAY BE NEEDED IN SPECIAL PURPOSE PRESENTATIONS

Authoritative Literature

Guidance on disclosures in special purpose financial statements is found in AR-C 80.18, AR-C 80.A28–.A31, AR-C 90.40 and AR-C 90.A81–.A83, and AU-C 800.15, AU-C 800.17, AU-C 800.A19–.A22, and AU-C 800.A34.

The SSARS state that for compiled or reviewed special purpose financial statements to be appropriate in form, those financial statements should include—

- A summary of significant accounting policies that includes a description of the special purpose framework and a description of the differences between the framework and GAAP (it is not necessary to quantify the differences).

- Disclosures similar to those required by GAAP when the financial statements include items that are the same as or similar to those included in GAAP-basis financial statements.

The SSARS also include much of the disclosure information found in AU-C 800. However, AU-C 800 still includes more guidance on this topic, primarily in the application and other explanatory material. Therefore, this section includes references to both the SSARS and auditing literature when applicable. As the level of service (financial statement preparation, compilation, review, or audit) should not impact what it means for financial statements to be fairly presented, this approach seems appropriate.

AR-C 60.26(b) requires the accountant to determine whether the framework selected by management for the preparation of the entity's financial statements is acceptable. Thus, the accountant needs to evaluate whether the financial statement framework achieves fair presentation. AU-C 800.17 provides guidance on what constitutes fair presentation for special purpose financial statements; AU-C 800.A19–.22 and Appendix B, *Fair Presentation and Adequate Disclosures*, (AU-C 800.A34) provide additional guidance. Much of that information is also included the SSARS as explained in the remainder of this section. Relevant AU-C 800 guidance not included in the SSARS is also discussed in the remainder of this section.

Disclosure of the Basis of Presentation

AR-C 80.18 and AR-C 90.40 require that special purpose financial statements include a description of the financial reporting framework, a summary of significant accounting policies, and a description of how the framework used differs from GAAP. (The effects of such differences need not be quantified.) The summary of significant accounting policies is discussed in more detail below. See the discussion of the exception for compilations of financial statements that omit substantially all disclosures earlier in this lesson.

If special purpose financial statements are prepared in accordance with a contractual basis of accounting, AR-C 80.19 and AR-C 90.41 state that the financial statements also should adequately describe any significant interpretations of the contract on which the financial statements are based. If such information is not described, the accountant should modify his or her report.

Disclosures for Similar GAAP Items

When special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, AR-C 80.18, AR-C 80.A31, AR-C 90.40, and AR-C 90.A83 state that informative disclosures similar to those required by GAAP are necessary to achieve fair presentation. The following bullets present application and other explanatory material guidance provided by AU-C 800 that is not included in the SSARS.

a. AU-C 800.A20 states that financial statements prepared on a tax or modified cash basis of accounting usually reflect depreciation, long-term debt, and owners' equity. Thus, the informative disclosures for depreciation, long-term debt, and owners' equity in such financial statements would be comparable to those presented in GAAP financial statements.

b. AU-C 800.A21 states that special purpose financial statements may substitute qualitative information for quantitative information required by GAAP or otherwise communicate the substance of the required disclosures. For example, special purpose statements may be able to sufficiently convey the significance of sales or leasing to related parties or major customers by disclosing estimated percentages of revenues rather than amounts required in GAAP presentations.

c. Appendix B, *Fair Presentation and Adequate Disclosures*, (AU-C 800.A34) provides the following examples to illustrate how special purpose financial statements might provide information that communicates the substance of those requirements, without modifying the format of the special purpose financial statements:

(1) To communicate sufficient information about the future principal reductions of long-term debt, special purpose statements might disclose the repayment terms in a note instead of presenting a summary of principal reduction during each of the next five years.

(2) To communicate information about the effects of accounting changes, discontinued operations, and extraordinary items, special purpose financial statements might disclose such information in a note instead of following the GAAP presentation requirements in the statement of results of operations, using those terms, or disclosing net-of-tax effects.

(3) Rather than presenting expenses by their functional classifications in certain industries such as for nonprofit organizations, a statement of activities might present expenses according to their natural classifications and include a note that provides estimated percentages to communicate information about expenses incurred by major program and supporting services.

(4) Instead of providing the amounts of, and changes in, unrestricted and temporarily and permanently restricted classes of net assets in certain industries such as for nonprofit organizations, a statement of assets and liabilities might report total net assets or fund balances and a related statement of activities could report changes in those totals. Finally, a note to the financial statements could provide information about the restrictions on those amounts and on any deferred restricted amounts, describe the major restrictions, and provide information about significant changes in restricted amounts using estimated or actual amounts or percentages.

Other Informative Disclosures Required by GAAP

AU-C 800.17 states that additional disclosures, beyond those specifically required by the basis of accounting used to prepare the special purpose financial statements and related to matters not specifically identified on the face of those statements, might also be necessary for special purpose financial statements to achieve fair presentation.

a. AU-C 800.A22 states that such disclosures may include matters about related party transactions, restrictions on assets and owners' equity, subsequent events, and significant uncertainties. In such circumstances, special purpose financial statements should (1) include the same disclosures required by GAAP or (2) otherwise communicate the substance of the GAAP requirements.

b. Appendix B, *Fair Presentation and Adequate Disclosures*, (AU-C 800.A34) clarifies that GAAP disclosure requirements not relevant to the measurement of an item need not be considered. It provides the following illustrations:

(1) Fair value disclosures for debt and equity securities are not relevant when the basis of presentation used to prepare the special purpose financial statements does not adjust the cost of such securities to their fair value.

(2) Disclosures related to actuarial calculations for contributions to defined benefit plans are not relevant in special purpose financial statements prepared in accordance with the cash or tax basis of accounting.

(3) Disclosures related to the use of estimates are not relevant in a special purpose presentation that uses no estimates, such as a presentation in accordance with the cash basis of accounting.

The SSARS also include guidance on providing additional disclosures, when necessary, to achieve fair presentation. AR-C 80.08(a)(iii) and AR-C 90.09(a)(iii) state that as a condition for accepting a compilation or review engagement of an entity's financial statements, among other things, the accountant should obtain management's acknowledgement that it understands its responsibility for the fair presentation of the financial statements. (Obtaining management's acknowledgement is satisfied through the use of the engagement letter, as discussed later in this lesson.) When the financial statements are prepared using a special purpose framework, this includes providing additional disclosures beyond those specifically required by the framework if needed to achieve fair presentation.

In summary, this course recommends that:

a. The discussion of the basis of presentation required by the SSARS and AU-C 800.15 may be brief and only needs to describe the primary differences from GAAP. Quantifying differences is not required.

b. If the financial statements contain amounts for which GAAP would require disclosure, the statements should either provide the relevant disclosure or provide information that communicates the substance of that disclosure. Applying that guidance involves (1) identifying financial statement items for which GAAP would require disclosure, (2) deciding whether the GAAP disclosure requirement is relevant to the basis used, and (3) if the requirement is relevant, deciding whether to follow that requirement or to meet the objective of that requirement through other means. Generally, that decision can be made based on efficiency.

c. If GAAP sets forth requirements that apply to the presentation of financial statements, special purpose financial statements should either comply with those requirements or provide information that communicates the substance of those requirements.

d. A statement of cash flows is not required in special purpose presentations. However, if a presentation of cash receipts and disbursements is presented in a format similar to a statement of cash flows or if the entity chooses to present such a statement, the statement should either conform to the requirements for a GAAP presentation or communicate the substance of the GAAP requirements.

e. If GAAP would require disclosure of other matters, the need for that same disclosure or disclosure that communicates the substance of those requirements should be considered.

Summary of Significant Accounting Policies

The notes to the financial statements should include a summary of accounting policies that describes the following:

a. *Basis of Accounting Used to Prepare the Financial Statements.* The description only needs to name the basis; for example:

   (1) Cash basis—"the basis of cash receipts and disbursements."

   (2) Modified cash basis—"the basis of cash receipts and disbursements, with some assets and liabilities recorded" or "the modified cash basis."

   (3) Tax basis—"the basis of accounting used for income tax reporting" or "the accrual basis of accounting used for income tax purposes."

b. *Primary Differences between the Basis of Accounting Used and GAAP.* Generally, the primary differences are those that individually have a material effect on the financial statements. Immaterial differences need not be mentioned. Differences can be identified by looking for items in the statement of financial position that would be accounted for differently under GAAP. As discussed above, the SSARS state that quantifying the effects of differences in the description of the basis is unnecessary. Additionally, AR-C 80.A30 and AR-C 90.A82 state that the description of how the basis of accounting used to prepare the special purpose financial statements differs from GAAP ordinarily only includes the material differences between GAAP and the special purpose framework. The guidance further clarifies that the remaining differences (that is, the differences that are not material) need not be described or quantified. As a practical matter, accountants normally can quickly estimate whether the effect of a difference is likely to be material. If unsure, however, it is a best practice to disclose the difference.

   Sometimes there may be no material differences between GAAP and the basis used. That may occur, for example, when an entity uses the tax basis of accounting solely to comply with a partnership agreement or continues to use a modified cash basis that was first used when the differences were material. In that situation, it is a best practice to disclose that there are no material differences.

Generally, FASB ASC 235-10-50-1 requires an entity to disclose in its GAAP financial statements all of the significant accounting policies used to prepare the statements. In particular, FASB ASC 235-10-50-3 requires an entity to disclose any of its accounting policies that involve a selection from existing acceptable alternatives, industry peculiarities, and unusual or innovative applications of accounting principles. Other pronouncements also require disclosure of accounting policies, such as the requirement of FASB ASC 360-10-50-1 to disclose depreciation methods.

This course recommends that the preceding guidance be followed in presentations prepared using the cash, modified cash, or tax basis of accounting. Therefore, in addition to the description of the basis, the statements should disclose the accounting policies significant to the presentation.

Typically, the description of the basis can be provided together with the description of other significant accounting policies. It is a best practice to start the summary of significant accounting policies with the description of the basis. If only a few accounting policies are significant, the policies may be described in a single note. If there are too many significant policies to describe in a single note, the policies may be described individually. Often, accounting policies can be described sufficiently through the description of the major differences from GAAP. As mentioned in item b. above, only material differences between GAAP and the special purpose framework need to be presented. For example, if the entity has several items that are accounted for differently under the special purpose framework than they would be under GAAP, but only the difference in how depreciation is calculated is material, a description of the depreciation difference is all that would need to be presented.

INCLUDING CASH TO ACCRUAL CONVERSIONS

Some business entities prepare financial statements using GAAP but report for income tax purposes on the cash basis. For those entities, it may be helpful to present a conversion of pretax income to taxable income as supplemental information to the financial statements. The accountant's compilation or review report on the financial statements should indicate the level of responsibility the accountant took for the supplementary information. The AICPA's *Code of Professional Conduct* considers activities such as preparing cash to accrual conversions to be nonattest services.

ENGAGEMENT LETTERS AND REPRESENTATION LETTERS

The agreed-upon terms of a preparation, compilation, or review engagement should be documented in an engagement letter. For a preparation engagement, the engagement letter should include identifying the financial reporting framework used to prepare the financial statements. Thus, identification of the applicable special purpose framework is required in the engagement letter.

In both a compilation and review engagement, the engagement letter also identifies the special purpose framework used for the preparation of the financial statements when the framework is other than GAAP. Additionally, management should acknowledge its responsibility for selecting the applicable financial reporting framework and determining that it is acceptable and for including all informative disclosures that are appropriate for the applicable special purpose framework. The required disclosures were discussed earlier in this lesson.

Representation letters are required only for review engagements. There are not any required representations unique to special purpose financial statements other than the need to identify the special purpose framework used when the financial statement framework is other than GAAP.

REQUIREMENTS FOR REPORTING ON SPECIAL PURPOSE FRAMEWORKS

An in-depth discussion of the requirements relating to compilation and review reports for financial statements presented in accordance with GAAP is beyond the scope of this course. More information is available in *PPC's*

Guide to Compilation and Review Engagements. When reporting on compiled and reviewed financial statements prepared using a special purpose framework, AR-C 80.18–.21 has additional requirements for compilation reports, and AR-C 90.40–.44 has additional requirements for review reports as explained below—

- The accountant should modify the compilation or review report when the financial statements do not include disclosure of the basis of presentation (including all of the items discussed in the "Disclosure of the Basis of Presentation" paragraph) or disclosures for similar GAAP items (as discussed in the "Disclosures for Similar GAAP Items" paragraph). If the compiled financial statements omit substantially all disclosures, then this requirement does not apply, as explained earlier in this lesson.

- The accountant should modify the compilation or review report if financial statements prepared under the contractual basis of accounting do not adequately describe any significant interpretation of the underlying contract upon with the financial statements are based.

- The accountant's compilation or review report should (a) make reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances when management has a choice of financial reporting frameworks, and (b) when the financial statements are prepared in accordance with a regulatory basis or contractual basis of accounting, describe the purpose for which the financial statements are prepared or refer to a note that contains such information.

- The accountant's compilation or review report should include a separate paragraph (a) indicating that the financial statements are prepared in accordance with the applicable special purpose framework, (b) referring to a note included in the financial statements that describes the framework (an exception to this requirement for compilations was explained earlier in this lesson), and (c) stating that the special purpose framework is a basis of accounting other than GAAP. In a review engagement, the separate paragraph in the report should be an emphasis-of-matter paragraph with an appropriate heading.

- The accountant's review report should include an other-matter paragraph with an appropriate heading that restricts the use of the report when the financial statements are prepared in accordance with a contractual basis, regulatory basis, or an other basis of accounting meeting the criteria listed at AR-C 90.61. No such requirement exists for compilation reports. However, paragraph 2.78 of the AICPA Guide says that the accountant is never precluded from including a restricted use paragraph in a compilation report.

SELF-STUDY QUIZ

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

14. What title would be most appropriate for the balance sheet in a set of financial statements prepared using the modified cash basis?

    a. Balance sheet.

    b. Statement of Assets, Liabilities, and Equity (Capital)—Cash Basis.

    c. Statement of Cash Receipts or disbursements.

    d. Statement of Cash Flows—Cash Basis.

15. What is the most common way for changes in retained earnings to be disclosed in special purpose financial statements?

    a. In the stockholder's equity section of the statement of assets, liabilities, and equity.

    b. In a combined statement of income and retained earnings.

    c. In a separate statement of retained earnings.

    d. In the notes to the financial statements.

16. Penelope is engaged to review a set of financial statements prepared using the tax basis. Which of the following changes might Penelope have to make to her review report?

    a. Her report would be modified if any significant interpretation of the underlying contract is not described.

    b. Her report should include an other-matter paragraph that restricts the use of her review report.

    c. Her report should include an emphasis-of-matter paragraph that indicates a special purpose framework was used.

    d. Her report should make reference to the fact that she was responsible for determining that the special purpose framework was acceptable.

SELF-STUDY ANSWERS

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

14. What title would be most appropriate for the balance sheet in a set of financial statements prepared using the modified cash basis? **(Page 303)**

    a. Balance sheet. [This answer is incorrect.AR-C 80.A28 and AR-C 90.A81 indicate that because cash basis and tax basis statements do not purport to present financial position and results of operations in accordance with GAAP, they ought not be titled or otherwise referred to as "Balance Statement" without appropriate modification.]

    b. Statement of Assets, Liabilities, and Equity (Capital)—Cash Basis. [This answer is correct. Because this statement does not present financial position and results of operations in accordance with GAAP, it is important for the statements to convey this to the users. One method for doing so is by choosing an appropriately descriptive title. A balance sheet prepared using the modified basis of accounting would be in compliance with AR-C 80.A28 and AR-90.A81 if it used a title such as Statement of Assets, Liabilities, and Equity (Capital)—Cash Basis. Another option for the title would be Balance sheet—Cash Basis.]

    c. Statement of Cash Receipts or disbursements. [This answer is incorrect. The pure cash basis has a single asset and no liabilities. Accordingly, there is no need to present a balance sheet. Instead a single statement titled "Statement of Cash Receipts and Disbursements" is ordinarily presented. However, this would not be appropriate if there were modifications to the pure cash basis.]

    d. Statement of Cash Flows—Cash Basis. [This answer is incorrect. This would be an appropriate title for a statement of cash flows prepared using the cash basis, but not a balance sheet.]

15. What is the most common way for changes in retained earnings to be disclosed in special purpose financial statements? **(Page 304)**

    a. In the stockholder's equity section of the statement of assets, liabilities, and equity. [This answer is incorrect. Even though it is permitted, disclosing changes in retained earnings on the statement of assets, liabilities, and equity is not commonly found in practice, except in certain computer-prepared financial statements. While that presentation sufficiently discloses changes in retained earnings when net income is the only change, it can be unwieldy and confusing when there are numerous changes.]

    b. In a combined statement of income and retained earnings. [This answer is correct. Disclosing changes in retained earnings in a combined statement of income and retained earnings is the method most frequently used in practice and is recommended by this course. In that presentation, the statement of retained earnings is presented as a continuation of the statement of revenues and expenses. Net income is followed in the statement by the retained earnings balance at the beginning of the period and the items that affected retained earnings during the period, which are totaled to arrive at the retained earnings balance at the end of the period.]

    c. In a separate statement of retained earnings. [This answer is incorrect. When the changes are numerous or complex, it may be preferable to present a separate statement of retained earnings; however, this is not the most common method for making the disclosure. When a separate statement of retained earnings is presented, it usually begins with the balance of retained earnings at the beginning of the period and then lists the changes during the period, which are totaled to arrive at the balance at the end of the period.]

    d. In the notes to the financial statements. [This answer is incorrect. This method of disclosure would be permissible; however, it is not the most common method of disclosure under these circumstances. It is also not the method recommended by this course.]

16. Penelope is engaged to review a set of financial statements prepared using the tax basis. Which of the following changes might Penelope have to make to her review report? **(Page 310)**

    a. Her report would be modified if any significant interpretation of the underlying contract is not described. [This answer is incorrect. The accountant should modify a compilation or review report if financial statements prepared under the *contractual basis of accounting* do not adequately describe any significant interpretation of the underlying contract upon which the financial statements are based. However, since Penelope's client used the tax basis, not the contractual basis, this modification would not apply.]

    b. Her report should include an other-matter paragraph that restricts the use of her review report. [This answer is incorrect. The accountant's review report should include an other-matter paragraph with an appropriate heading that restricts the use of the report when the financial statements are prepared in accordance with a contractual basis, regulatory basis, or an other basis of accounting meeting the criteria listed at AR-C 90.61. Since Penelope's client used the tax basis, she will not need to include this other-matter report.]

    c. Her report should include an emphasis-of-matter paragraph that indicates a special purpose framework was used. [This answer is correct. The accountant's compilation or review report should include a separate paragraph (1) indicating that the financial statements are prepared in accordance with the applicable special purpose framework, (2) referring to a note included in the financial statements that describes the framework, and (3) stating that the special purpose framework is a basis of accounting other than GAAP. In a review report, such as the one Penelope would prepare in this scenario, the separate paragraph in the report should be an emphasis-of-matter paragraph with an appropriate heading.]

    d. Her report should make reference to the fact that she was responsible for determining that the special purpose framework was acceptable. [This answer is incorrect. The accountant's compilation or review report should make reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances when management has a choice on financial reporting frameworks. The responsibility for making this determination would not belong to Penelope.]

Lesson 3: Personal Financial Statements

INTRODUCTION

The term *personal financial statements* refers to financial statements that present the personal assets and liabilities of an individual or group of related individuals (a family). The term does not include financial statements presenting the financial position or results of operations of unincorporated business enterprises such as proprietorships or partnerships.

CPAs are frequently asked to prepare, compile, or review personal financial statements for use in obtaining credit, for income tax planning, for estate or retirement planning purposes, or for public disclosure by candidates for public office. Such statements are clearly within the scope of the Statements on Standards for Accounting and Review Services (SSARS); thus the CPA is required to comply with the standards applicable to preparation, compilation, and review engagements.

This lesson contains guidance on the compilation and review of personal financial statements. Financial statement preparation services performed in connection with personal financial statements are beyond the scope of this course, but more information is available in *PPC's Guide to Compilation and Review Engagements*.

Personal Financial Statements Guidance

FASB ASC 274, *Personal Financial Statements*, is the principal authoritative literature dealing with preparing personal financial statements. It establishes the estimated current value basis of accounting as GAAP for personal financial statements.

Two-column Presentation (Estimated Current Value and Historical Costs)

Personal financial statements prior to 1983 were prepared on the historical cost basis of accounting. It also was recommended practice to present estimated current values as supplementary information. Thus, typical personal financial statements were prepared in columnar form, showing historical costs in one column and estimated current values in another column.

Two-column presentations also seem to be acceptable under FASB ASC 274. However, under FASB ASC 274, the estimated current value basis is GAAP, and the historical cost basis is supplementary information.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine what entity is covered by personal financial statements, the basis of the presentation, the form and content of the presentation, and how to use the estimated current value basis of accounting.
- Recognize the typical elements of personal financial statement engagements, including those specific to both compilations and reviews, and how to deal with reporting issues for such engagements.
- Assess common issues related to personal financial statement engagements using a variety of case studies.

THE ENTITY TO BE COVERED BY PERSONAL FINANCIAL STATEMENTS

Personal financial statements may be prepared for—

a. An individual.

b. A married couple.

c. A larger family group.

Ownership Information

Typically, personal financial statements present the combined assets and liabilities of a married couple and sometimes their dependent children. When such combined statements are presented, it may be useful to disclose each individual's interest in the net assets shown in the combined statements in an additional statement or in a footnote.

When personal financial statements are prepared for only one of a group of joint owners of assets (or when additional statements are prepared for each individual owner), only the share that the individual has a right to as a beneficial owner under the property laws of the state should be included as part of his or her assets (FASB ASC 274-10-45-8).

When property is held in joint tenancy or as community property, the legal status of the separate equities of the parties may not be clear; thus, the advice of an attorney may be required to determine whether the property interest should be included in the financial statements and, if so, the proper allocation under the applicable state laws (FASB ASC 274-10-45-8). When such property is included in the combined personal financial statements of a married couple or other family group, full disclosure of the circumstances is generally necessary.

BASIS OF PRESENTATION

Estimated Current Value Basis

Because the primary focus of personal financial statements is the individual's assets and liabilities, and because users of personal financial statements generally consider estimated current value to be more relevant for their decisions, FASB ASC 274-10-35-1 requires that personal financial statements present assets at their estimated current values and liabilities at their estimated current amounts. Using the estimated current value basis of accounting prescribed for use in personal financial statements is discussed later in this lesson.

Cash or Accrual?

FASB ASC 274-10-25-1 also states that assets and liabilities should be recognized on the accrual basis, not on the cash basis.

Special Purpose Framework

According to FASB ASC 274-10-35-1 and 35-2, personal financial statements presented in accordance with GAAP should include all assets and liabilities recorded under accrual recognition principles, and those assets and liabilities should be included at their estimated current values and amounts. AR-C 80.05 and AR-C 90.05 define a special purpose framework. The most common special purpose framework, tax basis personal financial statements, are statements that present assets and liabilities based on recognition and valuation principles promulgated by federal income tax law.

Personal financial statements prepared on an accounting basis that meets the SSARS's definition of a special purpose framework (see the discussion in Lesson 2) are considered special purpose framework statements. That may result in preparing personal financial statements on one of the following bases:

a. *Cash Basis.* Using the "pure" cash basis, the only asset reflected on the financial statement is cash, there are no liabilities, and only cash receipts and disbursements are reported as increases and decreases in net assets.

b. *Modified Cash Basis.* Under the modified cash basis, the pure cash basis is modified to report certain assets and liabilities, generally at the amounts that would be reported under either the historical cost basis or the estimated current value basis.

c. *Tax Basis.* Assets and liabilities under the tax basis are measured in accordance with the principles the individual uses for federal or other income tax reporting.

d. *Historical Cost Basis.* The historical cost basis generally measures the individual's assets and liabilities in accordance with GAAP for reporting entities other than individuals.

The practical benefit of financial statements prepared in accordance with a special purpose framework is the ability to present financial statements on the basis of accounting normally used by the individual without listing each departure from GAAP. Whenever cost-justified, it is a best practice for the accountant to encourage the presentation of GAAP financial statements regardless of the basis on which the individual's records are kept.

FORM AND CONTENT OF PERSONAL FINANCIAL STATEMENTS

Statement of Financial Condition

The basic objective of personal financial statements is to present financial position at a point in time. Therefore, a balance sheet type of presentation is the basic personal financial statement.

FASB ASC 274-10-45-4 recommends that the basic personal financial statement be titled "Statement of Financial Condition" and include all of the following:

a. Assets presented at their estimated current values.

b. Liabilities presented at their estimated current amounts.

c. A provision for estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases.

d. Net worth at a specified date.

FASB ASC 274-10-45-7 recommends that assets and liabilities be shown in order of liquidity and maturity. Classification as current and noncurrent is not appropriate because an individual's financial affairs do not usually involve an operating cycle.

FASB ASC 274-10-20 recommends the use of the term *net worth* to designate the difference between assets and liabilities after deducting the provision for estimated income taxes on the differences between the estimated current values of assets and estimated current amounts of liabilities and their tax bases. The estimated tax provision should be presented between *liabilities* and *net worth* on the statement of financial condition (FASB ASC 274-10-45-12). When a financial reporting framework other than GAAP is used, it is a best practice for the design of the statement to be the same; however, it would not use terms that are normally associated with current value presentations, such as *financial condition* and *net worth*. For example, *assets and liabilities* and *net assets* could be used in place of those terms.

Statement of Changes in Net Worth

The personal affairs of individuals do not constitute a business enterprise. Therefore, a statement presenting results of operations is *not* a basic personal financial statement. FASB ASC 274-10-45-4b recommends a "Statement of Changes in Net Worth" title. This should present the major sources of increases and decreases in the individual's net worth. Major sources of increases in net worth might include—

a. Income.

b. Increases in the estimated current values of assets.

c. Decreases in the estimated current amount of liabilities.

d. Decreases in estimated income taxes on the differences between estimated current values of assets and the estimated current amounts and tax bases.

Major sources of decreases in net worth might include—

a. Expenses.

b. Decreases in the estimated current values of assets.

c. Increases in the estimated current amount of liabilities.

d. Increases in estimated income taxes on the differences between estimated current values of assests and the estimated current amounts and tax bases.

The statement of changes in net worth does not attempt to present net income and is not required for a fair presentation of financial condition. The presentation of a statement of changes in net worth is *optional* according to FASB ASC 274-10-45-4.

In practice, the statement of changes in net worth is infrequently presented because creditors do not normally consider it necessary. When a special purpose framework is used, it is a best practice for the financial statement to not use titles and terms customarily associated with current value presentations. For example, the statement title could refer to changes in *net assets* or *equity*, depending on the caption used in the statement of assets and liabilities.

Comparative Financial Statements

FASB ASC 274-10-45-5 states that the presentation of comparative financial statements of the current period and one or more prior periods may sometimes be desirable because it is more informative than presentation for only a single period. Comparative financial statements, however, are not required.

Business Interests

FASB ASC 274-10-45-9 states business interests (including proprietorships, joint ventures, S corporations, and partnerships) that constitute a large part of the individual's total assets should be shown separately from other investments. The estimated current value of an investment in a separate entity, such as a closely held corporation, a partnership, or a sole proprietorship, should be shown in one amount as an investment as long as the entity is marketable as a going concern. The assets and liabilities of the separate entity should *not* be combined with personal assets and liabilities. The disclosure requirements are listed later in this section.

Assets and liabilities of a limited business activity not conducted as a separate business entity, e.g., an investment in real estate and a related mortgage, should be presented as separate amounts, particularly if a large portion of the liabilities may be satisfied with funds from sources unrelated to the investment (FASB ASC 274-10-45-10).

Problems When Financial Statements Are Not Available

If current financial statements of the closely held business are not available, the accountant may be faced with problems in determining the estimated current value of the individual's investment as well as in meeting the disclosure requirements. In these situations, the accountant can compile personal financial statements based on the individual's representation of the estimated current value. However, while the accountant is not required in a compilation to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the individual, at a minimum, it is a best practice for the accountant to obtain an understanding of the method(s) by which the individual determined the estimated current value and then consider whether the method is appropriate in light of the nature of the asset. If the accountant is not satisfied with the appropriateness of the method, or if he or she becomes aware that the estimate supplied by the individual is incorrect, incomplete, or otherwise unsatisfactory, the accountant needs to obtain additional or revised information. In some cases, it would be helpful to obtain historical financial statements in this latter situation to evaluate the appropriateness of the revised estimate. If the individual refuses to provide additional or revised information, the accountant needs to consider withdrawing from the compilation engagement.

In a review engagement, the accountant cannot rely solely on the individual's representation of the estimated current value of a closely held business. The AR-C 90 requires the accountant to apply appropriate inquiry and analytical procedures to the individual's estimate. Performance of such review procedures may not be possible absent the historical financial statements of the closely held business, and, accordingly, the accountant may be forced to withdraw from the engagement.

Second, assuming the *valuation* difficulties can be overcome without access to the current financial statements of the closely held business, the accountant may still have to modify the compilation (unless substantially all disclosures are omitted) or review report because of the omission of disclosure of summarized financial information. If such statements have not been prepared, the accountant may recommend expansion of the engagement to assist with their preparation. However, the accountant's procedures on this summarized financial information go beyond merely obtaining enough data to draft a note. Disclosures in notes are considered to be part of the basic financial statements, and, accordingly, the accountant also applies (as dictated by the engagement) compilation or review procedures to the disclosures. For example, if the accountant is engaged to review the individual's financial statements, he or she needs to also apply inquiry and analytical procedures in sufficient depth to the historical financial statements of the closely held business to give review assurance on the note information. If the financial statements of the closely held business have been audited or reviewed by another CPA, it may be necessary to obtain the other CPA's report. AR-C 90.25 states that during a review engagement the accountant is required to obtain and read any other accountant's report on the financial statements of a significant component.

Personal Effects

Personal effects, such as objects of art, jewelry, and household furnishings, should be included in personal financial statements if they are material (FASB ASC 274-10-55-3). If material personal effects are omitted, the accountant's report would refer to the omission as a departure from the applicable financial reporting framework.

Future Interests

Future interests are nonforfeitable rights to receive future sums. According to FASB ASC 274-10-35-11, the estimated current value of a future interest should be included in personal financial statements only if it has all of the following characteristics:

a. The right is for a fixed or determinable amount.

b. The right is not contingent on the holder's life expectancy or the occurrence of a particular event, such as disability or death.

c. The right does not require future performance of service by the holder.

Some practitioners have questioned the meaning of "contingent on the holder's life expectancy." Does this phrase mean that a right to receive an annuity over the remainder of the beneficiary's life is contingent on the holder's life expectancy, and thus should not be included? This course suggests that the answer is no and that including a future interest based on a holder's life expectancy is appropriate. However, the life expectancy of the holder is used to determine the amount at which such an interest is included. In contrast, a future interest that is receivable upon attaining a certain age or upon being alive at the time of someone else's death are contingent events and should not be recorded. Examples of future interests that frequently have all of the characteristics listed in the previous paragraph include guaranteed minimum portions of pensions, vested interests in pension or profit sharing plans, deferred compensation contracts, beneficial interests in irrevocable trusts, remainder interests in property subject to life estates, annuities, and fixed amounts of alimony for a definite period.

Social Security Benefits

According to AICPA Technical Q&A 1600.03, social security benefits to be received based on the future life expectancy of an individual should not qualify as an asset in personal financial statements. Both FASB ASC 274-10-35-11 and Q&A 1600.03 state that the right to future income which is contingent on the holder's life expectancy or the occurrence of a particular event do not qualify as a recognizable asset for the personal financial statements. The situation discussed in the previous paragraph describes when the income is being received currently and the life expectancy is used to determine the value of the income stream. This is analogous to when an individual is drawing social security and the right to the income is no longer contingent on the holder's life expectancy and requires no future performance on the individual's part. Instead, the life expectancy is used only to determine the value of the future income stream. However, if the individual is not yet drawing social security, the amount would not be included in personal financial statements. In that situation, the amount is not determinable, as (a) the amount would vary depending upon which retirement age the individual chooses, (b) rights to social security are contingent on the individual reaching a specific retirement age, and (c) social security may require future performance if the individual has not yet earned retirement benefits.

Noncancelable Commitments

The estimated current amount of a noncancelable commitment should be included in personal financial statements only if it has all of the following characteristics (FASB ASC 274-10-35-13):

a. The commitment is for a fixed and determinable amount.

b. The commitment is not contingent on others' life expectancies or the occurrence of a particular event, such as disability or death.

c. The commitment does not require future performance by others.

Commitments that frequently have all of these characteristics include fixed amounts of alimony for a definite future period and charitable pledges. Operating leases are examples of noncancelable commitments that generally do *not* have all of the characteristics necessary for inclusion as a liability in the statement of financial condition.

Income Taxes Payable

FASB ASC 274-10-35-14 states personal financial statements should include an accrual for the individual's unpaid income tax liability for all completed tax years as well as an estimated amount for income taxes accrued for the elapsed portion of the current tax year to the date of the financial statements. The estimated amount for the current tax year should be based on the relationship of taxable income earned to date to total estimated taxable income for the year, net of taxes withheld or paid as quarterly estimated tax payments. Income taxes payable needs to include state and local, as well as federal, income taxes.

Disclosures

FASB ASC 274-10-45-13 requires that personal financial statements include sufficient disclosures to make the statements adequately informative. That is, disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the compilation or review report. The required disclosures may be made in the body of the financial statements or in the notes to the financial statements.

FASB ASC 274-10-50-2 states that the disclosures that shall be made include, but are not limited to:

a. Identification of the individuals covered by the statements.

b. That assets are presented at their estimated current values and liabilities at their estimated current amounts.

c. Either (1) the methods used in determining the estimated current values of major assets and the estimated current amounts of major liabilities or (2) the methods used in determining the major categories of assets and liabilities.

d. Changes in the methods discussed in c. above from one period to the next.

e. Description of the nature of joint ownership for property held jointly by the individual and other parties.

f. If the individual's investments are material and are concentrated in one or a few industries, the names of the companies (or industries) and the estimated current value of the securities or investments.

g. If the individual has a material investment in a closely held business, at least the following:

   (1) The name of the company and the individual's percentage of ownership.

   (2) The nature of the business.

   (3) Summarized financial information about assets, liabilities, and results of operations for the most recent year based on the financial statements of the business, including information about the basis of presentation (for example, accrual historical cost basis, income tax basis, cash basis) and any significant loss contingencies.

h. Description of intangible assets and their estimated useful lives.

i. The face amount of the life insurance the individuals own.

j. Description of nonforfeitable rights not included in the financial statements because they do not have the characteristics required for accrual, e.g., pension based on life expectancy.

k. The following tax information:

   (1) The methods and assumptions used to compute the estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases.

   (2) A statement that the income tax provision will probably differ from the amounts of income taxes that might eventually be paid because those amounts are determined by the timing and the method of disposal, realization, or liquidation and the tax laws and regulations in effect at the time of disposal, realization, or liquidation.

   (3) Unused operating loss and capital loss carryforwards.

   (4) Other unused deductions and credits with expiration periods, if applicable.

   (5) The differences between the estimated current values of major assets and the estimated current amounts of major liabilities or categories of assets and liabilities and their tax bases.

   (6) The excess or deficit of the estimated current values of major assets or categories of assets over their tax bases.

l. Maturities, interest rates, collateral, and other pertinent details relating to receivables and debt.

m. Noncancelable commitments that do not have all of the characteristics required for accrual, e.g., operating leases.

In addition to the above, other disclosures required by GAAP that are relevant to personal financial statements also need to be considered, e.g., related-party transactions, certain contingencies, subsequent events, and lease information. An often overlooked disclosure of a subsequent event is a decline in the value of an asset after the financial statement date. Such declines often occur with marketable securities that experience significant reductions in quoted prices after the financial statement date but before issuance of the accountant's report. If these declines are material, the accountant needs to consider supplementing the financial statements with pro forma data giving effect to the loss in value as if it had occurred at the date of the statement of financial condition.

Another disclosure that is sometimes included in personal financial statements relates to open tax years. Many practitioners who provided this disclosure provided it in all situations due to the previous AICPA Technical Q&A 5250.15, which indicted that a description of tax years that remain subject to examination should be provided regardless of whether the entity has uncertain tax positions. However, in March 2015, the AICPA withdrew this Q&A after FASB members indicated that the disclosure of open tax years is only necessary when an entity has uncertain tax positions.

Because FASB ASC 740, *Income Taxes*, applies to all entities without exception (that is, there is no specific exclusion for individuals), many accountants believe disclosures about open tax years need to be included in personal financial statements. Other accountants disagree, citing the lack of a reference to disclosures about open tax years in the supplemental checklist used for personal financial statements by peer reviewers. (While that checklist refers to FASB ASC 740, it relates only to uncertainties from the perspective of calculating estimated income taxes on asset appreciation and does not specifically address open tax years.) Although nothing precludes the inclusion of the disclosure of open tax years, this course recommends that the disclosure of open tax years only to be provided when the personal financial statements have significant tax positions that do not meet the more-likely-than-not criterion. Such significant tax positions particularly may occur for high net worth individuals who may be more likely to take aggressive tax positions on their returns.

Contingencies, Risks, and Uncertainties. Estimating current values of assets and liabilities, by its very nature, involves a certain degree of uncertainty. Also, the estimated current value of an asset or liability is often contingent on the occurrence or nonoccurrence of some future event. For that reason, disclosure of contingencies, risks, and uncertainties inherent in using estimated current values generally is unnecessary in personal financial statements. The uncertainty is adequately communicated by disclosing that assets are presented at their estimated current values and liabilities at their estimated current amounts. However, if the value or amounts of specific assets or liabilities are particularly uncertain, disclosure of the uncertainty is not prohibited. Or if a specific contingency or uncertainty exists, such as a going concern uncertainty or a pending lawsuit affecting the valuation of the individual's interest in a closely held business, disclosure needs to be considered.

Other disclosures required by FASB ASC 275-10-50 include nature of operations and concentrations. This information is generally readily apparent in personal financial statements without additional specific disclosure.

THE ESTIMATED CURRENT VALUE BASIS OF ACCOUNTING

Definitions

FASB ASC 274-10-35-1 states that personal financial statements shall present assets at their estimated current values and liabilities at their estimated current amounts. Technical Q&A Q&A 1600.04, "Presentation of Assets at Current Values and Liabilities at Current Amounts in Personal Financial Statements," notes that the definitions of *current values* for assets and *current amounts* for liabilities for personal financial statements are not meant to be the same as *fair value*, as defined in FASB ASC 820, *Fair Value Measurements*. The practice aid states that FASB ASC 820 did not consider the reporting of personal financial statements, and the FASB did not amend the definitions of estimated current values and current amounts for personal financial statements as part of its codification process.

FASB ASC 274-10-20 defines the *estimated current value* of an asset as "the amount at which the item could be exchanged between a buyer and seller, each of whom is well informed and willing, and neither of whom is compelled to buy or sell." Disposal costs (such as real estate or brokerage commissions) should be considered if they are expected to be material (FASB ASC 274-10-55-2).

FASB ASC 274-10-35-12 states that payables and other liabilities should be presented in personal financial statements as "the discounted amount of cash to be paid." The discount rate used should be the rate implicit in the transaction in which the debt was incurred. If, however, the debt can be discharged currently at a lower amount, the debt should be presented at the lower amount.

Methods of Determining Estimated Current Value

The most preferable method of determining estimated current value is to base the estimate on recent transactions involving similar assets and liabilities in similar circumstances (for example, published or quoted market prices). When recent sales information is not available, FASB ASC 274-10-55-1 recommends that one of the following be used:

a. Capitalization of past or prospective earnings.

b. Liquidation value.

c. Adjustment of historical cost based on changes in a specific price index.

d. Appraisals.

e. Discounted amounts of projected cash receipts and payments.

Consistency in the Application of the Methods

No matter what method is used, it should be applied consistently from one period to the next unless circumstances change (FASB ASC 274-10-35-3). If the method used to determine the estimated current value or amount of an item is significantly changed, disclosure should be made in the notes to the financial statements (FASB ASC 274-10-50-2d). If the change in method is made simply at the client's discretion and is not supported by changed facts or circumstances, the accountant's report would be modified for a GAAP departure.

Suggested Methods for Specific Assets

FASB ASC 274-10-35 and 274-10-55 provide the following guidance with regard to determining the estimated current values of specific items:

a. *Receivables.* Should be presented at the discounted amount of cash expected to be collected using appropriate interest rates at the date of the financial statements.

b. *Marketable Securities.* Should be valued using quoted market prices.

   (1) If the securities are traded on a securities exchange, the price used should be the closing price on the date of the financial statements, if the securities were traded on that date.

   (2) If the securities were not traded on that date, but published bid and asked prices are available, the value of the securities should be within the range of those prices.

   (3) If the securities are traded over the counter, the mean of bid prices, of bid and asked prices, or of the prices of a representative selection of broker-dealers quoting the securities may be used.

   (4) If the investor holds a large block of securities, the fact that the large block may not be salable at the price at which a small number of shares was recently traded should be considered and the price adjusted accordingly. Conversely, a controlling interest may be more valuable than a minority interest, and the price may again need to be adjusted.

   (5) Market prices may need to be adjusted if there are restrictions on the transfer of the securities.

c. *Options.* Should be presented at published prices, if available, or if published prices are not available, the value should be determined on the basis of the value of the asset subject to option, considering exercise price and the length of the option period.

d. *Life Insurance.* Should be presented at cash value, less loans outstanding, if any.

e. *Investments in Closely Held Businesses.* Suggested methods of determining estimated current value include—

   (1) Multiple of earnings.

   (2) Liquidation value.

   (3) Reproduction value.

   (4) Appraisal.

   (5) Discounted amounts of projected cash receipts and payments.

   (6) Adjustment of book value or cost of the investor's interest.

   (7) Amounts specified in buy-sell agreements, if any.

   The estimated current value of an investment in a closely held business is probably the most difficult item to determine. None of the procedures listed in e. is preferable. In fact, not all of the procedures represent estimated current value. Individual circumstances need to be considered, and the method used needs to be the one most appropriate to the entity. It is important to keep in mind that the basic objective is to approximate the amount for which the investment could be exchanged between a buyer and a seller, each of whom is well informed and willing, and neither of whom is compelled to buy or sell. It is also important to remember that if the estimated current value is based on book amounts, the investee needs to use the accrual basis of accounting. If the investee keeps its books on the cash or tax basis, the amounts used in determining estimated current value need to be adjusted to conform to the accrual basis.

f. *Real Estate.* Estimated current value may be based on—

(1) Sales of similar property in the area.

(2) Discounted amounts of projected cash flows.

(3) Appraisals based on estimates of selling prices and selling costs obtained from independent real estate agents or brokers familiar with similar properties in similar locations.

(4) Appraisals used to obtain financing.

(5) Assessed value for property taxes, including consideration of the basis for such assessments and their relationship to market values in the area.

g. *Intangible Assets.* Should be presented at the discounted amount of projected cash receipts and payments, using an interest rate appropriate at the date of the financial statements, if both the amount and timing of cash flows can be reasonably estimated. Otherwise, cost may be the best estimate of the value of a purchased intangible.

h. *Future Interests.* Should be valued at the discounted amount of estimated future receipts, using an interest rate appropriate at the date of the financial statements. The following example illustrates valuation of a future interest. (The case studies later in this lesson also provide information about valuing future interests in trusts.)

Facts:

1. Jane Doe has a $40,000 interest in her employer's profit sharing plan, 70% of which is vested.

2. The plan provides that benefits under $30,000 are payable in one lump sum, one year after separation from employment. The benefits continue to accrue interest at 10% for that year.

3. Current interest rates are 10% on similar investments.

Results: Jane's interest in the profit sharing plan should be represented in the statement of financial condition at $28,000 ($40,000 × .70). Discounting is not necessary since the benefits continue to earn interest.

i. *Payables and Other Liabilities, Including Noncancelable Commitments.* Should be presented at the discounted amount of cash to be paid. The interest rate used should be that implicit in the transaction in which the debt was incurred. If the debt can be discharged currently at a lower amount, it should be presented at the lower amount. These principles are illustrated in the following example:

Facts:

1. In 20X1, John Doe purchased 50 acres of land for $200,000, to be paid $10,000 per year for 20 years without interest.
2. Comparable mortgage loans were being granted with an 8% interest rate at the time of the 20X1 transaction.
3. At the date of the statement of financial condition (20X6), John Doe owed $150,000 on the note.
4. At the date of the statement of financial condition (20X6), he was considering an offer from the owner of the note to allow John to repay it for a total sum of $68,109, which represents the discounted value of $10,000 a year for 15 years, assuming a 12% interest factor.

Results: The discounted amount of cash to be paid based on the interest rate implicit in the transaction (8%) is $85,595. Since John has a clear opportunity to discharge the debt currently at a lower amount ($68,109), the liability should be presented in John's statement of financial condition at the lower amount.

Range of Values

Several acceptable methods for arriving at an estimated current value were listed above. A situation may arise where use of several of the acceptable methods may result in a significant range of possible estimated current values. In exercising professional judgment when a range of values exists, the accountant should consider the following factors:

a. If the range of values results because of different methods used by the client to arrive at the estimated current value, the accountant needs to first obtain an understanding of the methods by which the individual determined the range of estimated current values, then consider which method is most appropriate in light of the nature of the asset. Once inappropriate methods and their results are discarded, the range of possible values may be narrowed significantly enough to allow the client to select one.

b. If the preceding procedure does not significantly reduce the number of reasonable methods and their resulting range of values, there may be a tendency to recommend the selection of a value at the midpoint of the range or, conservatively, at the low end of the range. However, it is important to remember that as long as the method chosen is acceptable, the accountant would not modify his or her compilation report even if the highest value in the range was chosen. Of course, the method used by the client should be adequately disclosed in the notes to the financial statements (FASB ASC 274-10-50-2c). Also, in some situations, the range of values that results from applying different acceptable methods may be informative to the users and can be disclosed. However, there is a danger in disclosing the range of values for one asset and being silent about possible ranges of values of other assets, i.e., it implies a level of precision about the estimated current values of other assets that may not be warranted.

c. Another important consideration in counseling the client is to explain that once a method is selected, is to be consistently used in future periods unless there is a change in circumstances. Otherwise, a change in a subsequent year to an alternative method would be a departure from GAAP. Additional discussion appears later in this lesson.

d. If the value selected by the individual is based on an inappropriate method, the compilation or review report would be modified because of a GAAP departure.

Estimated Income Taxes on Differences between Estimated Current Values and Amounts and Tax Bases

FASB ASC 274-10-35-15 states that a provision should be made for estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases, including consideration of negative tax bases of tax shelters, if any. The provision should be computed as if the estimated current values of all assets had been realized and the estimated current amounts of all liabilities had been *liquidated on the statement date*, using applicable tax laws and regulations, considering recapture provisions and carryovers. If assets include an interest in one or more tax deferred retirement plans, e.g., pension and profit sharing plans, individual retirement accounts, or 401(k) plans, any penalty tax for early withdrawal should also be considered (FASB ASC 274-10-55-1).

The estimated income taxes should be presented *between liabilities and net worth* in the statement of financial condition (FASB ASC 274-10-45-12). In addition, the methods and assumptions used to compute the estimated income taxes should be fully disclosed (FASB ASC 274-10-50-2k).

The practitioner's options when the tax bases of assets are unavailable are discussed later in this lesson.

SELF-STUDY QUIZ

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

17. Which of the following statements best describes an aspect of personal financial statements?

    a. The basic personal financial statement is most similar to a statement of cash flows.

    b. Personal financial statements must only cover a single individual.

    c. Assets and liabilities can be recognized on the cash basis.

    d. The assets of a business should be shown separately from personal assets.

18. Assuming all other characteristics are met, a noncancelable commitment would be included in personal financial statements under which of the following circumstances?

    a. The commitment is for a fixed amount.

    b. The commitment depends on someone's death.

    c. The commitment requires future performance by another individual.

    d. It cannot be related to personal effects.

19. What method should be used for determining the estimated current value of life insurance on personal financial statements?

    a. Cash value minus any outstanding loans.

    b. Quoted market prices.

    c. The discounted amount of future cash receipts and payments.

    d. Sales of other life insurance contracts of similar value.

SELF-STUDY ANSWERS

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

17. Which of the following statements best describes an aspect of personal financial statements? **(Page 320)**

    a. The basic personal financial statement is most similar to a statement of cash flows. [This answer is incorrect. The basic objective of personal financial statements is to present financial position at a point in time. Therefore, a balance sheet type of presentation is the basic personal financial statement.]

    b. Personal financial statements must only cover a single individual. [This answer is incorrect. Personal financial statements may be prepared for an individual, a married couple, or a larger family group.]

    c. Assets and liabilities can be recognized on the cash basis. [This answer is incorrect. FASB ASC 274-10-25-1 states that assets and liabilities for personal financial statements should be recognized on the accrual basis, *not* on the cash basis.]

    d. The assets of a business should be shown separately from personal assets. [This answer is correct. FASB ASC 274-10-45-9 states business interests (including partnerships, joint ventures, S corporations, and partnerships) that constitute a large part of the individual's total assets should be shown separately from other investments. The assets and liabilities of the separate entity should *not* be combined with personal assets and liabilities.]

18. Assuming all other characteristics are met, a noncancelable commitment would be included in personal financial statements under which of the following circumstances? **(Page 321)**

    a. The commitment is for a fixed amount. [This answer is correct. According to FASB ASC 274-10-35-13, the estimated current amount of a noncancelable commitment should be included in personal financial statements only if it meets all of the appropriate characteristics. One of those three characteristics is that the commitment be for a fixed or determinable amount.]

    b. The commitment depends on someone's death. [This answer is incorrect. To be included in personal financial statements, per to FASB ASC 274-10-35-13, a noncancelable commitment should *not* be contingent on others' life expectancies or the occurrence of a particular event, such as disability or death.]

    c. The commitment requires future performance by another individual. [This answer is incorrect. Under to FASB ASC 274-10-35-13, for a noncancelable commitment to be included in personal financial statements it should *not* require future performance by others.]

    d. It cannot be related to personal effects. [This answer is incorrect. Personal effects such as objects of art, jewelry, and household furnishings, would be included in personal financial statements if they are material. However, per to FASB ASC 274-10-35-13, the characteristics of noncancelable events to be included in personal financial statements have nothing to do with whether or not the commitment is related to a personal effect.]

19. What method should be used for determining the estimated current value of life insurance on personal financial statements? **(Page 325)**

    a. **Cash value minus any outstanding loans. [This answer is correct. FASB ASC 274-10-35 and 274-10-55 provide guidance for determining the estimated current values of specific items. Per this guidance, life insurance should be presented at cash value, less loans outstanding, if any.]**

    b. Quoted market prices. [This answer is incorrect. According to FASB ASC 274-10-35 and 274-10-55, this method would be used for valuing marketable securities, not life insurance.]

    c. The discounted amount of future cash receipts and payments. [This answer is incorrect. Based on the guidance in FASB ASC 274-10-35 and 274-10-55, intangible assets (not life insurance) should be presented at the discounted amount of projected cash receipts and payments, using an interest rate appropriate at the date of the financial statements, if both the amount and timing of cash flows can be reasonably estimated. Otherwise, cost may be the best estimate of the value of the purchased intangible.]

    d. Sales of other life insurance contracts of similar value. [This answer is incorrect. There are several methods for determining estimated current value for real estate under FASB ASC 274-10-35 and 274-10-55, including sales of similar property in the area. This method would not be used to value life insurance.]

CONSIDERATIONS FOR PERSONAL FINANCIAL STATEMENT ENGAGEMENTS

General

Using the estimated current value basis of accounting in personal financial statements creates some unique considerations for accountants engaged to compile or review such statements.

Acceptance of Clients

Before accepting an engagement, the accountant should consider the SSARS requirements related to acceptance and continuance of engagements in AR-C 60.25–.26.

Personal financial statement engagements usually require a greater degree of client participation than do other engagements. In many cases, client interviews and telephone or email inquiries are an integral part of the process of gathering data. Therefore, it is important to be especially careful to consider a potential client's ability and willingness to provide sufficient accounting data and reliable estimates of current values.

Engagement Letters

AR-C 80.10 and AR-C 90.11 require the accountant to establish an understanding with the client and document it through a written communication (that is, an engagement letter) with the client for all compilation and review engagements. Engagement letters can be especially important in personal financial statement engagements to—

a. dispel any notion that the accountant is responsible for estimates of current value,

b. identify the applicable financial reporting framework for the financial statements, and

c. link the client's cooperation to the fee, since the cooperation of the client is vital to completing the engagement.

AR-C 80.11 and AR-C 90.12 require that the understanding with the client be signed by both the accountant or the accountant's firm and the client.

Inadequate Accounting Records/Gathering Information

Individuals generally do not maintain formal financial or accounting records. As a result, often not all assets and liabilities are recorded. AR-C 80.16 and AR-C 90.A26 state that the accountant should not compile or review financial statements from records that he or she believes to be an inadequate basis for financial statements. The lack of adequate records, however, can often be overcome by providing additional accounting services.

Before compiling or reviewing personal financial statements, the accountant needs to consider whether it is necessary to perform additional accounting services. Generally, such services will consist of gathering necessary information by inquiry of the client and review of available financial records. If additional services are performed, the accountant needs to consider whether these services constitute nonattest services.

Sometimes it may be necessary to contact bankers, lawyers, financial consultants, or others who might have knowledge of the individual's financial affairs. In addition, the following illustrative sources might provide information useful in preparing personal financial statements (this illustration is not meant to imply that all of the sources would need to be consulted to draft an individual's financial statements):

a. *Checkbooks, Bank Statements, and Savings Account Statements.* In addition to providing the individual's cash balance, a review of cash receipts and disbursements can give clues regarding other assets and liabilities. For example, cash receipts would lead the accountant to question whether it was generated by an asset that should be recorded in the financial statements, e.g., if interest or dividend income is noted, are the investments recorded? Cash disbursements are also sometimes related to assets and liabilities that should be recorded in the financial statements, e.g., a real estate tax payment would lead the accountant to question whether the real estate and related mortgage, if any, have been recorded.

b. *Broker's Statements.* Brokers usually send their clients a list of transactions during a period and a list of securities held at the end of each period. These statements also provide the individual's outstanding margin or cash balance.

c. *Income Tax Returns (and Revenue Agent's Reports, If Any).* The accountant considers whether all income-producing assets and tax liabilities have been recorded.

d. *List of Vault or Safe-deposit Box Contents.* Material assets listed would probably be recorded in the financial statements.

e. *Financial Records of Other Entities.* Financial statements or tax returns of separate entities, such as closely held businesses, trusts, or profit sharing or deferred compensation plans, may serve as a source of information regarding an individual's interest in the entities.

f. *Insurance Policies and Schedules.* A review of insurance policies and schedules may reveal assets that need to be recorded in the financial statements.

g. *Real Estate and Personal Property Tax Returns.* The accountant considers whether the assets being taxed are recorded in the financial statements and whether any taxes due have been recorded.

h. *Wills.* The accountant considers whether all assets bequeathed are recorded in the financial statements.

i. *Leases.* The accountant considers whether all assets and liabilities related to leasing activities are properly recorded in the financial statements.

In addition to identifying assets and liabilities to be included in the individual's financial statements and determining their estimated current values or amounts, remember that the tax bases of the assets and liabilities are also needed obtained in order to calculate the estimated income tax provision on the difference between the estimated current values and amounts and the tax bases.

Client Representation Letters

Although AR-C 90 only requires that representation letters be obtained from the client in engagements to *review* personal financial statements, it is a best practice for the accountant to obtain a client representation letter in *all* personal financial statement engagements because—

a. The informal nature of personal financial records usually requires that accountants place greater reliance on the client's representations to ensure completeness of the statements.

b. The estimated current values and amounts of assets and liabilities provided by the client have a significant effect on the statements.

c. A client representation letter can help to clarify that responsibility for the estimates of current value, even if developed by the accountant, rests with the client.

Inability to Obtain Tax Bases of Assets

Frequently the tax bases of certain of the individual's assets and liabilities cannot be easily determined. This is particularly true for assets obtained by inheritance or trade or acquired a number of years prior to the statement date. The absence of reliable tax basis numbers makes calculation of the estimated income taxes on differences between estimated current values and amounts and their tax bases difficult. In such situations, it is a best practice to use a conservative estimate of the missing tax basis when computing the tax provision. A note disclosing the use of the estimated tax basis would be appropriate, but modification of the accountant's report would ordinarily not be necessary.

Some accountants believe this inability to obtain the tax basis of a material asset constitutes a scope limitation that precludes the accountant from issuing a report. Others treat the situation as a GAAP departure and report accordingly. However, the problem might be avoided by establishing a reasonable and conservative estimate of the basis.

COMPILING PERSONAL FINANCIAL STATEMENTS

Applicability of AR-C 80

Standards for compilation of financial statements prescribed by AR-C 80 are applicable to the compilation of personal financial statements in the same manner as to the compilation of other financial statements. Thus, in compiling personal financial statements, the accountant must meet the performance requirements for compilation engagements.

The accountant should apply AR-C 80 procedures in the context of the engagement to compile personal financial statements. For example, the requirement in AR-C 80.12 to obtain an understanding of the applicable financial reporting framework and the significant accounting policies to be used to prepare the financial statements would be considered to be a requirement that the accountant should have knowledge of those items applicable to personal financial statements.

Responsibility for Estimated Current Values

The standards for accounting and review services prescribed by AR-C 80 do not require an accountant to verify the reasonableness of information supplied to him or her in a compilation engagement. Accordingly, the accountant can compile personal financial statements based on the client's estimate of current values and amounts.

AR-C 80.12 requires the accountant to obtain an understanding of the applicable financial reporting framework and the significant accounting policies to be used to prepare the financial statements. For personal financial statements this may include obtaining an understanding of the methods by which the individual determined the estimated current values and amounts, and consider whether the methods are appropriate for the asset or liability. AR-C 80.14 requires the accountant to request additional or revised information from the individual if the accountant becomes aware that the individual's estimate is incorrect, incomplete, or otherwise unsatisfactory. If the individual refuses to provide new information, the accountant should consider withdrawing from the engagement (AR-C 80.16). If the accountant believes that the method is inappropriate or has been inconsistently applied and the estimated current value is not revised, the accountant's report should be modified because of a GAAP departure (AR-C 80.18).

With the exception of compiled personal financial statements that omit substantially all disclosures, the financial statements, including the notes, should disclose the method used to determine the estimated current values and amounts, even when such values or amounts are based on the individual's estimate (FASB ASC 274-10-50-2). If such disclosure is not made, the accountant should modify the accountant's report for a GAAP departure (AR-C 80.18).

In some cases, a specialist, such as an appraiser, may assist the client in determining the estimated current value or amount of an asset or liability. The use of a specialist is sometimes helpful but is not required. If a specialist is used in a compilation engagement, the accountant has no responsibility to inquire about the specialist's qualifications or reputation beyond understanding the stated qualifications of the specialist.

In many situations, particularly when the individual is unsophisticated in financial matters, the individual and the accountant will jointly develop the estimated current values. In such situations, the accountant should obtain the individual's approval and acceptance of responsibility for the values, preferably in writing (AR-C 80-A15).

Personal Financial Statements under AR-C 70

AR-C 70.01 states that the requirements of AR-C 70 do not apply when the accountant prepares personal financial statements to be included in a written personal financial plan that the accountant prepares.

If the financial statements are primarily intended for obtaining credit or other third party use, the client may choose to engage the accountant to *prepare* the financial statements in accordance with the requirements of AR-C 70 or *compile* them in accordance with AR-C 80. Generally, the decision depends on whether the creditors or other third parties prefer a report on the financial statements submitted to them and on the accountant's willingness to be engaged to prepare financial statements.

REVIEWING PERSONAL FINANCIAL STATEMENTS

Applicability of the AR-C 90

Standards for the review of financial statements prescribed by AR-C 90 are applicable to the review of personal financial statements in the same manner as the review of other financial statements. Accordingly, to review personal financial statements, the accountant must meet the following requirements.

General Requirements

The accountant should possess (a) a level of knowledge of the accounting principles and practices applicable to personal financial statements and (b) an understanding of the individual's financial activities and financial position that will provide the accountant, through the performance of inquiry and analytical procedures, with a reasonable basis for expressing limited assurance that no material modifications are necessary to the financial statements for them to conform to the applicable financial reporting framework (AR-C 90.14-.16). Knowledge of the accounting principles and practices applicable to the personal financial statements implies that the accountant is thoroughly familiar with the requirements of FASB ASC 274.

Knowledge about the individual's activities and financial position includes a general understanding of—

a. the nature of the individual's assets and liabilities,

b. the sources of his income,

c. the nature of significant expenditures, and

d. the nature of material transactions with related parties.

The accountant's understanding of these matters is often obtained through experience with, and inquiry of, the individual whose financial condition is being presented.

Using the knowledge and understanding discussed in the preceding paragraphs, the accountant should perform inquiry and analytical procedures (AR-C 90.19–.23). At the completion of the inquiry and analytical procedures, the accountant should read the financial statements (as in a compilation) and consider whether they are appropriate in form and free from obvious material errors (AR-C 90.24). In this context, error refers to mistakes in the compilation of financial statements, including arithmetical or clerical mistakes, and in the application of accounting principles, including inadequate disclosure. Common disclosure inadequacies are listed later in this lesson.

Accountants must also meet their responsibilities for fraud and noncompliance with laws and regulations, the same as they would in all review engagements.

Inquiry and Analytical Procedures

In reviewing personal financial statements, the accountant should perform inquiry and analytical procedures sufficient to obtain review evidence that will provide a reasonable basis for obtaining limited assurance that there are no material modifications that need to be made to the financial statements to conform to GAAP (AR-C 90.19–.23).

AR-C 90.22 lists the required inquiries that the accountant should make of the client.

AR-C 90.19 states analytical procedures should normally consist of procedures designed to identify relationships, individual items, and estimated current values that appear unusual or indicate a potential material misstatement.

Such analytical procedures should include comparison of financial statement balances with those of prior periods and analysis of relationships within the financial statements, and, when relevant, relationships with nonfinancial information such as (this list is not all-inclusive)—

a. Ratio of marketable securities to dividend and interest income.

b. Ratio of debt to interest expense.

c. Ratio of real estate to property taxes.

d. Comparison between years of estimated current values for the same asset in relation to the nature of the asset and changes in the economic environment.

e. For closely held businesses, overall reasonableness test of the individual's method of arriving at estimated current values such as comparison with a multiple of historical book value or a multiple of earnings.

f. For real estate, computation of estimated current value per square foot (residential or commercial) or per acre (farmland) if such statistics are available (normally can be obtained by inquiry with the individual). Compare this per square foot or acre value to other comparable values in the area.

g. Computation of the overall effective tax rate associated with the difference between tax bases of assets and their estimated current values.

h. Computation of the overall effective tax rate for the expenses associated with the current year's realized income.

If the individual has a significant investment in a closely held business, the accountant would apply appropriate review procedures to financial statements of the closely held business. If other accountants have compiled, reviewed, or audited such entities, the accountant should obtain and read the other accountants' reports (AR-C 90.25).

The accountant should consider whether the results of the analytical procedures are consistent with responses to related inquiries (AR-C 90.21). Inconsistencies would ordinarily require the accountant to make additional inquiries or perform additional analytical procedures.

Finally, AR-C 90.91–.92 specifies what should be included in the accountant's documentation of each review engagement, including the documentation of his or her inquiry and analytical procedures.

Reading the Financial Statements

The accountant should read the financial statements to consider, on the basis of information coming to the accountant's attention (including the results of inquiries and analytical procedures), whether the financial statements appear to conform with the applicable financial reporting framework applied on a basis consistent with preceding periods (AR-C 90.24).

Obtaining a Representation Letter

AR-C 90.32–.36 requires accountants to obtain a representation letter from management in all review engagements. Therefore, accountants should obtain a representation letter when engaged to review personal financial statements.

REPORTING ON PERSONAL FINANCIAL STATEMENTS THAT HAVE BEEN COMPILED OR REVIEWED

This section applies only when the accountant issues a compilation or review report.

The Standard Reports

The form and substance of a compilation or review report issued in connection with personal financial statements would not differ from that used for commercial entities. Nevertheless, subtle differences in wording are caused by the nature of the estimated current value basis of accounting.

a. The use of different financial statement titles recommended by FASB ASC 274-10-45-4; i.e., "Statement of Financial Condition" instead of "Balance Sheet," and "Statement of Changes in Net Worth" instead of "Statements of Income, Retained Earnings, and Cash Flows."

b. Identification of the entity as the individuals themselves instead of a company, i.e., statement of financial condition of James and Jane Person instead of the balance sheet of XYZ Corporation.

c. Noting that the representations are those of the individuals instead of those of the management of a company.

d. Noting, in a review, that the inquiries were made of the individuals and not management.

Compiled Personal Financial Statements That Omit Substantially All Disclosures

AR-C 80.27 allows the accountant to issue a compilation report on financial statements that omit substantially all disclosures by adding a paragraph to the standard compilation report. This option is also available for personal financial statements, *except there is one added reporting requirement*. When personal financial statements omit substantially all disclosures and do not disclose that the assets are presented at their estimated current values and that liabilities are presented at their estimated current amounts, it is a best practice for the accountant to include the following sentence as the second sentence of the compilation report [emphasis added]:

> The financial statements are *intended to present* the assets of James and Jane Person at estimated current values and their liabilities at estimated current amounts.

While this sentence is not required, this course suggests that it is important in describing the applicable financial reporting framework and would still be included when substantially all disclosures are omitted. Note that the sentence uses the phrase *intended to present* instead of *presents*. The inclusion of *intended to* is necessary to prevent the accountant from giving a positive assurance statement because a compilation or review does not allow such assurances.

GAAP Departures

GAAP departures for personal financial statements fall into three categories—measurement, disclosure, and consistency. A list of common GAAP departures classified by these categories follows (the list is not all-inclusive):

a. Measurement departures.

   (1) Failure to record estimated taxes on the differences between estimated current values and amounts over their tax bases.

   (2) Presentation of an estimated current value based on an inappropriate valuation method.

   (3) Presentation of a material asset on a basis different from that used for the financial statements as a whole, e.g., material asset stated at cost in a GAAP (estimated current value) financial statement.

   (4) Omission of significant assets or liabilities, e.g., some liability accounts not recorded on the accrual basis.

b. Disclosure departures.

   (1) Failure to disclose the methods used to determine estimated current values.

   (2) Failure to disclose summarized financial information for closely held businesses.

   (3) Failure to disclose a significant subsequent event.

c. Consistency departures.

   (1) An unwarranted change between years in the method of determining estimated current values.

Quantification of the Effect of a Financial Reporting Framework Departure

AR-C 80.29–.33 and AR-C 90.56–.60 specifically address the accountant's responsibility for disclosing the dollar effect of a financial reporting framework measurement departure. AR-C 80.30 and AR-C 90.57 note that when an accountant concludes that a modification of the standard report is necessary, he or she should disclose the departure in a separate paragraph of the report. The disclosure should include the effects of the departure on the financial statements, if the individuals have determined such effects or they are known as the result of the accountant's procedures. In any event, the accountant does not have to determine the effects of a departure if the individuals have not done so, provided the accountant discloses in the report that such determination has not been made by the individuals.

When faced with a financial reporting framework measurement departure, the accountant needs to be extremely cautious in presenting a dollar effect for the departure in the accountant's report because:

a. the precision for determining the effect of the departure under an estimated current value basis is not as exact as it is for the historical cost basis, and

b. disclosing the dollar effect of the measurement departure may imply a level of assurance about the proposed revised value that is beyond the assurance of a compilation or review engagement.

Accordingly, in most situations, the accountant indicates in his or her report that management has not determined the dollar effect of the GAAP departure on the financial statements. However, the accountant should also be aware of AR-C 90.A104–.109 that discuss reporting when there is a significant GAAP (or applicable financial reporting framework) departure. This guidance suggests that the accountant consider a separate explanatory paragraph when there is a significant departure. The use of such an explanatory paragraph may be appropriate when a departure individually, or when viewed with other departures, becomes so pervasive that the financial statements lose their ability to communicate to the user. The failure to determine the dollar impact of a departure may not cause such a pervasive impact on the financial statements and, accordingly, would not automatically call for the use of an optional paragraph.

Paragraph 2.70 of the AICPA Guide: *Preparation, Compilation, and Review Engagements* (AICPA Guide) contains similar guidance for a compilation engagement.

GAAP Consistency Departures

FASB ASC 274-10-35-3 states that "the methods used to determine the estimated current values of assets and the estimated current amounts of liabilities should be followed consistently from period to period unless the facts and circumstances dictate a change to different methods." FASB ASC 274-10-50-2 states that changes in methods used to determine the estimated current values of major assets and the estimated current amounts of major liabilities from one period to the next should ordinarily be disclosed.

This type of financial reporting framework consistency departure would rarely occur because the individual should be able to demonstrate reasonable changes in facts and circumstances. A valid circumstance supporting a change could be the cost to the individual to continue the use of a prior method. For example, an appraisal from a specialist may have been used in prior periods to establish the estimated current value. This method may be too costly in subsequent years, causing the individual to change methods.

Uncertainties

Some practitioners may be uncomfortable about being associated with personal financial statements prepared on an estimated current value basis because this basis, for certain assets, is characterized by greater subjectivity and imprecision than the conventional, historical cost basis. Accordingly, there may be a temptation to emphasize the uncertainty of certain estimated current values in a separate paragraph of a compilation or review report by relying on guidance in AR-C 90.65–.68 on reporting on a going concern uncertainty in a review engagement. However, neither AR-C 80 nor AR-C 90 provide guidance on including an emphasis of matter or other matter paragraph in a report to draw attention to other types of uncertainties; but, neither do they prohibit it. In fact, paragraph 2.80 of the AICPA Guide states the accountant is not precluded from including an emphasis-of-matter or other-matter paragraph in the accountant's compilation report. And paragraph 1.183 of the AICPA Guide states the accountant should include an emphasis-of-matter paragraph in the accountant's review report if the accountant considers it necessary to draw the users' attention to a matter that is of such importance that it is fundamental to the users' understanding of the financial statements. In any event, it does not seem necessary to emphasize in the accountant's report an uncertainty related to use of the estimated current value basis of accounting.

Scope Limitations

AR-C 90.89 does not allow the accountant to modify his or her review report for a scope limitation, e.g., lack of available records, lack of response from the individual to an accountant's inquiry, etc. Common practice suggest this is also applicable to compilation reports. If faced with a serious scope limitation, AR-C 80.16 and AR-C 90.A26 generally require the accountant to withdraw from the engagement. This guidance is contrary to similar guidance in auditing literature, the latter allowing the auditor to issue an *except for* report or to disclaim an opinion instead of withdrawing.

When faced with a potential scope limitation, the exercise of sound professional judgment would lead the accountant to the correct solution. For example, if the accounting records are so poor, or the individual's knowledge of his financial affairs so limited that meaningful values cannot be generated, it would be wise to withdraw from the engagement. On the other hand, a lack of sophisticated records and of accounting knowledge by the individual does not mean that the resulting values presented in a statement of financial condition are unreasonable. Regardless of the condition of the records, if the accountant believes that the resulting financial statements are reasonable after his or her reading, the accountant would be able to issue a compilation report.

Reference to Internal Control

AR-C 60.26C requires that the engagement letter for a compilation and review engagement include a statement about management's responsibility for internal control relevant to the preparation and fair presentation of the financial statements. Some accountants have questioned whether this requirement applies in a personal financial statement engagement. The Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control—Integrated Framework* defines internal control as a process designed to provide reasonable assurance regarding the achievement of the entity's—

- operation effectiveness and efficiency,
- financial reporting reliability, and
- compliance with laws and regulations.

This definition is clear when discussing the responsibilities of management of a corporation, but may be confusing when applied to an individual(s). However, internal control does pertain to individuals, as well as corporations. The following are examples of internal controls in a personal financial statement environment—

- Awareness of all the assets and liabilities.
- Having, or being able to obtain, supporting documentation for the value of the assets and liabilities.
- Reconciliations of bank accounts.

Personal financial statements are different in that a sophisticated or formal control is not necessary. Individuals may not have formal controls, but they usually have controls that allow them to identify assets owned and liabilities owed.

SELF-STUDY QUIZ

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

20. Why might an accountant request a client representation letter when compiling personal financial statements?

    a. Representation letters are required under the AR-C 90.

    b. Personal financial records are often formal and detailed.

    c. Estimated current values are important to the statements.

    d. The accountant takes responsibility for any current values that he or she develops.

21. Charlotte is engaged to compile her client's personal financial statements. Which of the following will she need do during this engagement?

    a. Make inquiries and perform analytical procedures.

    b. Obtain an understanding of how her client estimated current values.

    c. Apply review procedures the financial statements of any closely held businesses.

    d. Verify the reasonableness of all information supplied to her for the compilation.

22. Which of the following would be treated as a *consistency departure* from GAAP?

    a. An unwarranted change in how estimated current values were determined from year to year.

    b. The omission of significant liabilities or assets.

    c. The failure to disclose a subsequent event.

    d. The presentation of a material asset using a different basis.

SELF-STUDY ANSWERS

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

20. Why might an accountant request a client representation letter when compiling personal financial statements? **(Page 333)**

    a. Representation letters are required under AR-C 90. [This answer is incorrect. The AR-C 90 only requires that representation letters be obtained from the client in engagements to *review* personal financial statements. Therefore, the requirement does not apply to compilations of personal financial statements. However, it is a best practice for the accountant to obtain a client representation letter in a compilation of personal financial statements due to the difficulties inherent in this type of engagement.]

    b. Personal financial records are often formal and detailed. [This answer is incorrect. The informal nature of personal financial records usually requires accountants place greater reliance on the client's representations to ensure completeness of the standards.]

    c. Estimated current values are important to the statements. [This answer is correct. The estimated current values and amounts of assets and liabilities provided by the client have a significant effect on the statements. Therefore, it is a best practice for the accountant to make sure to obtain a representation letter as support for these amounts, even in a compilation engagement.]

    d. The accountant takes responsibility for any current values that he or she develops. [This answer is incorrect. A client representation letter can help to clarify that the responsibility for the estimates of current value, even if developed by the accountant, rests with the *client*.]

21. Charlotte is engaged to compile her client's personal financial statements. Which of the following will she need do during this engagement? **(Page 334)**

    a. Make inquiries and perform analytical procedures. [This answer is incorrect. If Charlotte were reviewing her client's personal financial statements, she would need to perform inquiry and analytical procedures sufficient to obtain review evidence that will provide a reasonable basis for obtaining limited assurance that there are no material modifications that need to be made to the financial statements to conform to GAAP (AR-C 90.19-23). Since Charlotte is performing a compilation engagement, this is not required.]

    b. Obtain an understanding of how her client estimated current values. [This answer is correct. AR-C 80.12 requires the accountant to obtain an understanding of the applicable financial reporting framework and the significant accounting policies to be used to prepare the financial statements. For personal financial statements this may include obtaining an understanding of the methods by which the individual determined the estimated current values and amounts, and consider whether the methods are appropriate for the asset or liability. Therefore, this is a procedure Charlotte will need to perform for her compilation of personal financial statements to be in compliance with AR-C 80.12.]

    c. Apply review procedures the financial statements of any closely held businesses. [This answer is incorrect. If Charlotte were performing a review engagement instead of a compilation and the individual had a significant investment in a closely held business, Charlotte would need to apply appropriate review procedures to the financial statements of the closely held business. If other accountants have compiled, reviewed, or audited such entities, Charlotte would need to obtain and read the other accountant's reports as part of a review engagement.]

    d. Verify the reasonableness of all information supplied to her for the compilation. [This answer is incorrect. The standards for accounting and review services prescribed by AR-C 80 do not require the accountant to verify the reasonableness of information supplied in a compilation engagement. Accordingly, the accountant can compile personal financial statements based on the client's estimates of current values and amounts.]

22. Which of the following would be treated as a *consistency departure* from GAAP? **(Page 337)**

    a. **An unwarranted change in how estimated current values were determined from year to year. [This answer is correct. An unwarranted change between years in the method used to determine estimated current values is a common GAAP departure that is classified in the category of consistency departures. Information about consistency departures can be found in FASB ASC 274-10.]**

    b. The omission of significant liabilities or assets. [This answer is incorrect. The omission of significant assets or liabilities (e.g., some liability accounts not recorded on the accrual basis) is considered a measurement departure, not a consistency departure.]

    c. The failure to disclose a subsequent event. [This answer is incorrect. The failure to disclose a subsequent event is considered a disclosure departure from GAAP, not a consistency disclosure.]

    d. The presentation of a material asset using a different basis. [This answer is incorrect. Presentation of a material asset on a basis different from that used for the financial statements as a whole is considered a measurement departure, not a consistency departure. An example of this is when a material asset is stated at cost in GAAP financial statements instead of at its estimated current value.]

PERSONAL FINANCIAL STATEMENT CASE STUDIES

Computation of the Income Tax Liabilities—A Typical Engagement

Personal financial statements include two income tax liabilities: (a) a current tax and (b) an estimated tax on the difference between the estimated current value of assets and the estimated current amounts of liabilities and their tax bases (hereafter referred to as the *estimated future tax*). This case study illustrates the computation of both liabilities in a typical engagement. A flat rate of 28% has been used in the case studies.

Facts. Mr. and Mrs. Jack Smith have asked you to compile their statement of financial condition as of June 30, 20X4. The Smiths have never prepared financial statements before; thus, you will have to assist them in assembling a trial balance. You have obtained the following information from the Smiths:

a. On April 15, 20X4, Mr. and Mrs. Smith filed a request for automatic extension of their 20X3 tax return and paid $10,000 to the IRS. (The $10,000 was Mr. Smith's estimate of his remaining unpaid liability for 20X3.) Also at this date, the Smiths made a first-quarter 20X4 estimated payment of $5,000. On June 15, 20X4, the Smiths made another 20X4 estimated payment of $5,000. In July 20X4, the Smiths engaged you to prepare their 20X3 return at which time you noted that the Smiths had materially underestimated their 20X3 income, and thus owed additional 20X3 taxes of $25,000.

b. Mr. Smith owns a dry cleaning and laundry proprietorship from which he draws money, as needed, to live on. (He tries to draw the bulk of his annual profits in December of each year.) During the first six months of 20X4, Mr. Smith has drawn only $25,000 even though the proprietorship's profits through June 30 were $70,000. He estimates that the business will generate total net income of $100,000 in 20X4. Mrs. Smith received an annual royalty check of $50,000 in January, 20X4, for 20X3 sales of a novel she wrote. She estimates that she will receive a $40,000 royalty check in January 20X5 for 20X4 sales. (Assume she earns the income ratably during 20X4.)

c. As of June 30, 20X4, the Smiths have the following investments in marketable securities (assume there are no material dividends receivable):

Description	No. of Shares	Date Acquired	Total Cost	Total Market	Unrealized Gain (Loss)
ABC, Inc.	1,000	Oct. 20X3	$ 15,000	$ 10,000	$ (5,000)
Ajax Title	500	Sept. 20X2	2,500	6,250	3,750
Lemon Computer	5,000	Dec. 20X3	22,500	6,250	(16,250)
			$ 40,000	$ 22,500	$ (17,500)

d. Twenty-five years ago, the Smiths paid $20,000 for their home that is now appraised at $150,000. Mr. Smith estimates that he has spent about $50,000 on the home over the years, of which $10,000 was the cost of a swimming pool, $20,000 was the cost of a new addition, and $20,000 was for repairs and maintenance. Mr. and Mrs. Smith are in their late 50s.

e. Mr. Smith's dry cleaning-laundry business operates primarily out of a main store located by a busy intersection. The main store, which is owned by the Smiths, has all of the production equipment to process cleaning for five additional *drop-off* and *pickup* stores that are leased. The books of the proprietorship are maintained on the tax basis, and the business's summarized balance sheet at 6-30-X4 follows:

Cash	$ 25,000
Land	50,000
Building (net of straight line depreciation of $50,000)	100,000
Equipment (net of depreciation of $50,000)	50,000
Utility deposits	5,000
	$ 230,000

Mortgage note on main store	$ 100,000
Equipment note	25,000
	125,000
Proprietor's capital	
Balance 12-31-X3	60,000
20X4 earnings	70,000
20X4 draws	(25,000)
Balance 6-30-X4	105,000
	$ 230,000

The proprietorship's general ledger does not reflect accounts receivable associated with processed dry cleaning and laundry at the various retail outlets awaiting customer pickup. Mr. Smith estimates that the receivables associated with the processed cleaning amounts to $50,000. Recently, the main store was appraised at $600,000 (primarily because of its location), and Mr. Smith believes the equipment is worth $75,000.

f. Approximately five years ago, the Smiths bought a partnership unit in a large real estate partnership for $20,000, and they have deducted losses for tax purposes of $50,000 over the life of the investment. Mr. Smith believes the value of the real estate (a large hotel/convention complex) has appreciated at a rate of about 6% a year since his initial purchase and estimates the current value of his partnership unit at $30,000. The partnership was originated before ACRS depreciation rules were established, and Mr. Smith does not know if accelerated depreciation methods are used by the partnership.

g. All other assets and liabilities of the Smiths have, in all material respects, the same tax bases and estimated current values as follows:

Cash in checking account	$ 3,000
Jewelry	4,000
Cash value of life insurance	8,000
Autos	5,000
Home furnishings	25,000
Mortgage on home	4,000
Credit card charges	2,000

The Current Tax Liability. The current tax liability includes unpaid taxes from prior years (or unrecorded refunds) plus the estimated amount due on current year earnings to date (less withholdings or estimated tax payments for the same period). Income taxes for an interim period, e.g., through June 30, should be computed in accordance with FASB ASC 270-10 and FASB ASC 740-270. Basically, this means applying an estimated effective tax rate based on projected taxable income for the entire year to taxable income as of the interim date. (Lesson 1 explains in more detail the process of computing income taxes for an interim period.) Based on the facts in the previous paragraph the current tax liability is computed as follows:

a. First determine the estimated income tax liability on projected taxable income for 20X4 and then compute the projected effective tax rate:

20X4 projected adjusted gross income	
Mr. Smith's proprietorship income	$ 100,000
Mrs. Smith's January 20X4 royalty check	50,000
	150,000
Less personal exemptions, standard deduction and itemized deduction	(20,000)
Projected 20X4 taxable income	$ 130,000
Projected 20X4 taxes based on a flat 28% rate	$ 36,400

Projected effective tax rate $36,400 ÷ $150,000 = 24.3%

Note that in arriving at the 20X4 estimate, you can use the lowest tax rate alternative available to the Smiths. However, remember that the materiality necessary for a financial statement may not warrant the same amount of time needed to calculate the tax in an actual tax return filing. In other words, try to keep the calculation simple.

b. Because this is an interim 6-30-X4 financial statement, it is necessary to determine what portion of the total 20X4 liability computed in Step a. is appropriate for the first six months of 20X4. To accomplish this, gross income as of June 30, 20X4, is estimated. Then, the tax liability associated with this estimate is computed, based on the effective tax rate for the year. The following illustrates this computation:

Mr. Smith's proprietorship	
Earnings through June 30	$ 70,000
Mrs. Smith's royalty	
Earnings through June 30	50,000
Estimated gross income through June 30	120,000
Effective tax rate ($36,400 ÷ $150,000)	24.3%
Tax liability on six month earnings	$ 29,160

Note that all of Mrs. Smith's 20X3 royalty is included because it is both earned and received. None of Mrs. Smith's 20X4 royalty is included because, though earned, it will not be taxed in 20X4. A receivable for the portion ($20,000) of the royalty earned through June 30 should be included in the statement and is a factor in computing taxes on estimated current values in excess of tax bases.

c. The final step in arriving at the current liability is to consider the effect of prior year unpaid tax liabilities and current year estimates.

20X3 unpaid liability	$ 25,000
20X4 liability on earnings as of June 30, 20X4	29,160
20X4 1st quarter estimated payment	(5,000)
20X4 2nd quarter estimated payment	(5,000)
CURRENT TAX LIABILITY	$ 44,160

The Estimated Future Tax Liability. The following schedule summarizes the calculation of the estimated future tax liability on each asset that has a material tax and estimated current value difference.

Description	Income Tax Basis	Estimated Current Value	Unrealized Gain (Loss)	Effective Tax Rate %	Estimated Tax
Marketable securities	$ 40,000	$ 22,500	$ (17,500)	28%	$ (4,900)
Personal residence	50,000	150,000	100,000	—%	—
Proprietorship	105,000	525,000	525,000	28%	147,000
Real estate tax shelter	(30,000)	60,000	60,000	28%	16,800
Accrued royalty	—	20,000	20,000	28%	5,600
Estimated income tax on the difference between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases					$ 164,500

The following points explain how the schedule was completed:

a. The net unrealized loss on the marketable securities of $17,500 is a short-term capital loss, and, absent other capital gains, only $3,000 of the loss would be tax benefited in the calculation. However, as will be seen in the following discussion, the Smiths have substantial capital gains in excess of the $17,500 loss. Thus, the entire loss should enter into the estimated tax calculation at a capital gains rate of 28%.

b. The tax basis of the home and the related unrealized capital gain is determined as follows:

Original purchase price	$ 20,000
Swimming pool	10,000
New room	20,000
TAX BASIS	50,000
Estimated current value	150,000
CAPITAL GAIN	$ 100,000

Individuals can exclude up to $250,000 ($500,000 if married filing jointly) of realized gain from the sale of a principal residence. Accordingly, no tax is computed on the $100,000 gain.

c. A common valuation method for a closely held business is to estimate the current value of only those business assets that have experienced obvious appreciation in value. For other business assets and liabilities, book values and estimated current values are assumed to be the same (unless there has been an impairment in value of an asset below its book value). This appears to be the method Mr. Smith is using to value the proprietorship. Accordingly, the proprietorship trial balance should be adjusted to record the accounts receivable and to reflect the appreciation in value of the property and equipment. These adjustments and the resulting tax computation would appear as follows:

	Tax Basis	Estimated Current Value	Difference	Tax Rate %	Tax
Cash	$ 25,000	$ 25,000	$ —	—	$ —
Accounts receivable	—	50,000	50,000	28	14,000
Land and building	150,000	600,000	450,000	28	126,000
Equipment	50,000	75,000	25,000	28	7,000
Utility deposits	5,000	5,000	—	—	—
	$ 230,000	$ 755,000	$ 525,000		$ 147,000
Mortgage note	$ 100,000	$ 100,000	$ —	—	$ —
Equipment note	25,000	25,000	—	—	—
	125,000	125,000	—	—	—
Proprietor's capital	105,000	630,000	525,000	28	147,000
	$ 230,000	$ 755,000	$ 525,000		$ 147,000

Note that the unrecorded accounts receivable of $50,000 would be taxed at an ordinary income rate of 28%. Also, the gain on the equipment is taxed at 28% because of depreciation recaptured. As a final point before leaving this illustration, the estimated current value of the proprietorship would be recorded as a single line caption on the Smiths' statement of financial condition in the amount of $630,000. The notes to the financial statements would contain other details about the proprietorship as explained earlier in this lesson.

d. An investment in a real estate partnership sometimes has a negative tax basis, as in the case of the Smiths' investment. The tax calculation must reflect the negative basis as follows:

Tax Basis ($20,000 cost – $50,000 deductions)	Estimated Current Value	Difference	Tax Rate	Tax
$ (30,000)	$ 30,000	$ 60,000	28%	$ 16,800

e. The personal financial statements should show a $20,000 receivable for novel royalties earned, but not received, by Mrs. Smith in 20X4. (The royalty is assumed to be earned ratably during 20X4; therefore, half of the $40,000 annual total would be earned as of 6-30-X4.) This accrued royalty was not included in the current tax liability calculation above because it is not taxable in 20X4 to the Smiths, who are cash basis taxpayers. Consequently, the tax on this accrued income is computed in the estimated future tax calculation. The accrued royalty has a zero tax basis and a $20,000 estimated current value at 6-30-X4. The $20,000 difference would be taxed at the Smiths' ordinary income tax rate of 28%.

FASB ASC 274-10-35-15 requires the estimated future tax to be calculated using tax laws applicable at the financial statement date. Practitioners sometimes question whether the financial statements should disclose future tax rates if they will differ from those in effect at the financial statement date. Such disclosure is not required. Some firms recommend against disclosing future tax rates because tax rates may change. Furthermore, some clients tend to view the additional disclosure as excessive. However, other firms believe that the tax rates used in the financial statements should be disclosed. Also, it may be desirable to disclose future tax rates in some cases, e.g., if personal financial statements are prepared for clients on a continuing or recurring basis.

The resulting working trial balance assembled in the Smiths' engagement is presented in Exhibit 3-1. (This working trial balance is presented only to help clarify the case study. In an actual engagement, the accountant could probably bypass this step and immediately draft the financial statement.)

Exhibit 3-1

Working Trial Balance

Cash in checking account	$ 3,000
Royalty receivable	20,000
Cash surrender value of life insurance	8,000
Marketable securities	22,500
Investment in real estate tax shelter	30,000
Investment in proprietorship	630,000
Autos	5,000
Home	150,000
Home furnishings	25,000
Jewelry	4,000
Credit card bills payable	(2,000)
Mortgage on home	(4,000)
Current year income tax payable	(44,000)
Estimated income taxes	(164,500)
Net worth	(683,000)
	$ -0-

* * *

Recognition of an Interest in a Trust

One of the most difficult assets to handle in a personal financial statement is determining when to recognize an interest in a trust. Several terms used in the ensuing discussion are defined as follows:

- *Beneficiary.* An individual who is lawfully entitled to receive proceeds from property held in trust, but the title to the trust property is vested in another, such as a trustee.

- *Income Beneficiary.* An individual who receives the income from the trust property while the trust is in effect.

- *Remainderman (or Corpus Beneficiary).* The individual(s) designated to receive a future interest in property at the termination of the trust.

- *Grantor.* The person who establishes a trust. Also called creator, donor, settlor, or trustor.

- *Trustee.* A person who holds legal title to property in a fiduciary capacity for the benefits of others (beneficiaries) pursuant to a written trust instrument.

- *Inter Vivos Trust.* A trust created during the creator's lifetime (as compared to a testamentary trust created at death).

- *Testamentary Trust.* A trust set up in a will that becomes effective after death (as compared to an *inter vivos* trust created during the creator's lifetime).

FASB ASC 274-10-35-11 gives the accounting guidance for valuation of nonforfeitable rights to receive future sums, which is the general guidance for valuing an interest in a trust. The paragraph states that future interests should be presented as assets at their discounted amounts only when all of the following are true (future interests are discussed earlier in this lesson):

a. The rights are for fixed or determinable amounts.

b. The rights are not contingent on the holder's life expectancy or the occurrence of a particular event such as a disability or death.

c. The rights do not require future performance of service by the holder.

The following case studies illustrate how the preceding rules are applied.

Interest in a Testamentary Trust

The financial statements of the Everett Storm, Jr. Trust are presented in Exhibit 3-2 and Exhibit 3-3.

Exhibit 3-2

Statement of Trust Assets

EVERETT STORM, JR. TRUST
STATEMENT OF TRUST ASSETS
December 31, 20X4

	Corpus Account	Income Account
Cash	$ 20,000	$ 2,117
Certificates of deposit	860,000	—
Marketable securities	20,000	—
Investment in an apartment house	800,000	—
U.S. Government bonds	300,000	—
TOTAL ASSETS	$ 2,000,000	$ 2,117

See accompanying notes and accountant's report.

* * *

Jane Storm, age 34, the wife of the late Everett Storm, Jr., is the sole income beneficiary of the trust, having the right to all income earned from the trust assets during her lifetime. Jane does not have any rights to gains or losses realized from sales of trust assets during the life of the trust. Such transactions affect only the trust's corpus. Jane is also prohibited from invading the corpus of the trust except for an extreme financial emergency. Everett Storm III (Junior's son, who is nicknamed Rett) is a remainderman to the corpus of the trust at his mother's death. Based on these assumptions, the following paragraphs explore how the trust interest might be valued in three different situations: (a) Jane's personal financial statements, (b) Rett's separate personal financial statement, and (c) a combined personal financial statement of the family, i.e., Jane and her dependent son, Rett.

Exhibit 3-3

Statement of Cash Receipts and Disbursements

EVERETT STORM, JR. TRUST
STATEMENT OF CASH RECEIPTS AND DISBURSEMENTS
Year Ended December 31, 20X4

	Corpus Account	Income Account
CASH RECEIPTS		
Interest income	$ —	$ 83,000
Dividend income	—	2,000
Rental income	—	150,000
Sales of securities	309,000	—
	309,000	235,000
CASH DISBURSEMENTS		
Purchases of U.S. Government bonds	300,000	—
Repairs on rental property	—	15,000
Real estate taxes	—	5,000
Lockbox rental	—	50
Trustee's commission	—	5,000
Distributions to beneficiary	—	209,973
	300,000	235,023
EXCESS (DEFICIENCY)	9,000	(23)
CASH AT DECEMBER 31, 20X3	11,000	2,140
CASH AT DECEMBER 31, 20X4	$ 20,000	$ 2,117

See accompanying notes and accountant's report.

* * *

Jane's Income Beneficiary Value. The first step necessary to value Jane's income interest is to establish the expected annual income from the trust. For a large trust, this normally requires an analysis of the trust's financial statements. Referring to the trust's financial statements in Exhibit 3-2 and Exhibit 3-3, note that in 20X4, distributions to the beneficiary amounted to $209,973. Would it be realistic to assume that an annual income distribution of this amount could continue over Jane's lifetime? Such an assumption in this case study would probably be realistic because an annual distribution of approximately $200,000 represents a realistic 10% return on trust assets, and the trust assets appear to be soundly invested. However, if the nature of the trust assets were in different types of investments, for example oil and gas properties, or if the rate of return was unrealistic, establishing an expected annual distribution may be more difficult. The point to be made is that FASB ASC 274-10-35-11 requires that the rights to receive future sums must be *determinable*. A trust whose assets consist of an investment in a highly speculative research and development venture that has yet to generate trust income might not pass the *determinable test*, and thus, should not be recognized.

Assuming that an annual trust income distribution of $200,000 is deemed realistic, the next step would be to determine a reasonable term in years for payment of the annual distribution. The term of the trust is for Jane's life. If Jane is in good health, the remaining term could be computed by consulting a mortality table. If such a table reflected the life expectancy of a female at 70, Jane's remaining life expectancy would be 36 years (70 − 34 = 36).

After determining the expected annual income and the expected term, the final step is to discount the future value of the trust income stream to its present value. The determination of an appropriate discount rate is somewhat subjective, but it is a best practice for that rate to be representative of the interest rate that would be expected from an investment of comparable maturity and risk. A starting point in determining the discount rate is to compute the current rate of return on the trust corpus. In this illustration, investment income is $200,000 and the trust corpus is $2 million, which results in a 10% current rate of return. If this rate approximates what similar investments in today's market are earning, it could be used as the discount rate. However, assume the apartment investment in Exhibit 3-2 is not yielding a current rate. If the apartment investment was yielding a current rate, let's assume the overall rate of return on corpus would be increased to 12%. Using a compound interest table, the present worth of a series of 36 annual receipts of $1 at 12% is $8.1924. Using this factor, the present value of the income beneficiary interest is $1,638,480 ($200,000 × 8.1924), and this would be the value in Jane's financial statement.

Presumably, a trust asset of $1,638,480 would be material in any personal financial statement, and, accordingly, the accountant should consider disclosing the summarized financial statements of the trust in a note to the financial statement. While such a disclosure is not specifically discussed in FASB ASC 274, a significant investment in a trust is similar to a significant investment in a closely held business, and FASB ASC 274-10-50-2 does require disclosure of summarized financial statements for the latter.

Rett's Remainderman Value. To compute Rett's remainderman interest, the first step is to determine how much of the corpus can be expected to exist at his mother's death. Referring to Exhibit 3-2, the corpus of the trust at December 31, 20X4, was $2 million. Since the investments are managed by a reputable trust department, are conservative in nature, and are protected from all but emergency invasions by his mother, it would be reasonable to assume that the $2 million of the corpus would be available to Rett in 36 years, his mother's life expectancy. Again, the nature of the trust assets and the trust agreement can have a bearing on the determination of what amount of corpus, if any, should be recognized as an asset on the financial statements of a remainderman. For example, in Rett's situation, his right to the corpus of the trust is not contingent on any event (such as outliving his mother) or the requirement to perform a future service (two key parameters discussed previously). In other words, the corpus reverts to him or his estate regardless of what Rett might do. However, if the trust agreement stipulated that the corpus reverts to Rett only if he has a child (and he did not), or only if Rett is alive at his mother's death, then his remainderman right is contingent, and no value should be recognized in his financial statement.

Rett's remainderman interest would be computed by consulting a compound interest table for the present worth of $1 that is to be collected in one lump sum at the end of a given time. The present worth of $1 to be collected at the end of 36 years is $.0169 assuming a discount rate of 12%. (A discussion on determining the discount rate appeared earlier in this section.) Using this factor, the value of Rett's interest is $33,800 ($2 million × .0169).

The Value of the Trust in Combined Families' Financial Statements. FASB ASC 274-10-15-1 states that personal financial statements can be prepared for individuals or groups of related individuals (families). Thus, Jane can elect to prepare a financial statement that includes the assets of the family (Jane and her dependent son, Rett). In such a presentation, the value of the trust assets of the separate individuals would be combined. The value of the beneficiary interest computed above is $1,638,480, and the value of the remainderman interest computed in the previous paragraph is $33,800, or a combined total of $1,672,280, which is less than the current trust corpus of $2 million. The combined value will equal the current trust corpus whenever the estimated annual income stream from the trust as a percentage of corpus (the current rate of return on corpus) is equal to the discount rate used. In this illustration the current rate of return on the corpus is 10%, whereas a 12% discount factor was used. Again, this indicates that the corpus is generating a less than average yield, given the character of its assets.

As a final word of caution, an individual can be subject to severe legal penalties if he misrepresents the value of his assets and liabilities in a personal financial statement, especially a personal financial statement requested by a bank to secure a loan. If combined financial statements of a family include material assets belonging to children, which presumably a creditor would not have a right to, the financial statements need to clearly indicate in the accountant's report and title to the statement of financial condition that the assets and liabilities are those of the combined family. Also, the notes to the financial statement need to discuss this point. It may also be advisable to reflect the amount of the assets belonging to the children in the notes to the financial statement.

Wealthy Individual Does Not Desire to Present All of His Assets

Occasionally, an individual with substantial wealth will be asked to present a personal financial statement in connection with a loan guarantee or to qualify for certain investments. The purpose of this type of financial statement may be to show that the individual has a certain minimum net worth. Because of concerns about personal security for his family and to avoid the limelight of public attention, the individual may request that certain assets not be valued at estimated current value or that they be entirely omitted. The following options might be available in such circumstances:

a. Value certain assets at cost, or omit the assets entirely, and indicate a GAAP departure in the compilation or review report. Of course, the accountant considers whether the departure was made with the intention of misleading the reader by withholding certain facts about the asset (such as a lawsuit contingency or going concern problem associated with an investment in a closely held business). If the practitioner concludes that the individual's intent is to mislead a user, or that modification of the standard compilation or review report is inadequate to indicate the deficiency, he or she should withdraw from the engagement (AR-C 80.16 and AR-C 90.A93). Even if the practitioner concludes that the departure is adequately disclosed and it was not done with the intention to mislead a user, there could be severe legal penalties for intentionally misstating a personal financial statement. Therefore, this course recommends the following option.

b. Present the individual's statement of financial condition on the tax basis or historical cost basis of accounting. This option is illustrated in the following paragraph.

The effect of the second option, the use of a special purpose framework, can be illustrated by referring to the facts for Mr. and Mrs. Jack Smith the earlier case study. The value of the dry cleaning proprietorship investment changes significantly depending on which valuation method is used.

Estimated Current Value	Historical Cost	Tax Basis
$630,000	$155,000	$105,000

Note that the historical cost basis results in a higher value than the tax basis. The historical cost basis requires accrual accounting; thus the $50,000 in unrecorded receivables of the proprietorship would be included in the valuation. In summary, the use of a special purpose framework, especially when there are investments in closely held companies, can result in a net worth for the individual that is less than would be determined using the estimated current value basis of accounting.

Elimination of an Individual's Receivables or Payables on the Financial Statements of a Closely Held Business

Often an individual will have an investment in a closely held business and also have a personal receivable from, or payable to, the business. A question that occurs in such situations is whether the receivable or payable should be eliminated. The answer is no. Such receivables or payables have no bearing on valuing the investment. To illustrate, assume that Bob Rodgers owns 100% of Plugum Dry Drilling Company (a corporation). The tax basis financial statements of Mr. Rodgers and the GAAP financial statements of Plugum Dry follow:

Mr. Rodgers

Accounts receivable from Plugum	$ 100,000
Investment in Plugum	100,000
Other assets	500,000
	$ 700,000
Liabilities	$ 300,000
Net worth	400,000
	$ 700,000

Plugum Dry

Current assets	$ 2,000,000
Drilling rigs, net of $100,000 depreciation	400,000
Other fixed assets	600,000
	$ 3,000,000
Amount payable to Rodgers	$ 100,000
Other liabilities	1,900,000
Common stock	100,000
Retained earnings	900,000
	$ 3,000,000

Assume that the estimated current value of Plugum Dry is two times book value ($100,000 common stock and $900,000 retained earnings). Thus, the estimated current value is $2,000,000. This estimated current value is theoretically what Plugum Dry is worth after all assets are liquidated and all liabilities are paid, including the $100,000 account payable to Mr. Rodgers. The receivable or payable has no bearing on the evaluation. Mr. Rodgers' financial statements adjusted for the estimated current value of Plugum would be:

Accounts receivable from Plugum	$ 100,000
Investment in Plugum	2,000,000
Other assets	500,000
	$ 2,600,000
Liabilities	$ 300,000
Estimated income taxes on the difference between estimated current values of assets and estimated current amounts of liabilities and their tax bases [($2,000,000 − $100,000) × 28%]	532,000
Net worth	1,768,000
	$ 2,600,000

Elimination of Profit in Assets Sold to a Closely Held Company

A related question arises when an individual sells an asset to a closely held business at a profit. For example, assume in the case study above that Mr. Rodgers sold five drilling rigs to Plugum for $500,000, and those rigs cost him $250,000. Mr. Rodgers personally has recognized $250,000 in profit, and, correspondingly, the financial statements of Plugum reflect the capitalized profit in the book value of drilling rigs. Should any portion of the gain capitalized on Plugum's books be eliminated to arrive at the estimated current value of the investment?

The answer is not a clear-cut yes or no. Several methods may be used to determine the estimated current value of a closely held company. The objective of an appropriate valuation method is to arrive at a value indicative of an exchange between a willing buyer and seller. If the method used is based on a multiple of earnings, liquidation value, reproduction value, appraisal, or amount specified in a buy-sell agreement, the capitalized profit in the fixed asset would probably have no bearing because the value is not compiled directly from the amounts recorded on Plugum's financial statements. On the other hand, if the estimated current value of the investment is based solely on the net book value of Plugum's financial statements, the capitalized profit in the fixed assets could have a bearing on the valuation if it is apparent that the assets are capitalized at an inflated cost. The point to be made in such a situation is that some degree of professional skepticism may be warranted if the book values are used to arrive at the estimated current value.

Problems with Historical Cost Presentations

CPAs may sometimes be asked to include historical cost supplementary information in personal financial statements, as discussed at the beginning of this lesson. This section discusses issues that arise when CPAs prepare personal financial statements that include historical cost basis information.

When historical cost is used, a common question is whether the historical cost basis of certain assets could be presented at a value higher than the corresponding estimated current values of the same assets. For example, historical cost may be higher than estimated current values for marketable securities, automobiles, or other assets that have suffered depreciation in value.

Impairment of Long-lived Assets. Authoritative literature provides guidance for accounting for the inability to fully recover the carrying amount of current assets, e.g., marketable securities or inventory. As a general rule, the lower of cost or market principle would apply to *current* assets, and thus they generally are be adjusted to estimated current value if that amount were lower than historical cost. A few authoritative pronouncements also address specific types of noncurrent assets. See, for example, FASB ASC 320, FASB ASC 840, and FASB ASC 323. In addition, FASB ASC 360-10-05 provides guidance on the recognition and measurement of an impairment loss of a noncurrent asset.

An entity is required to consider the need to recognize a loss from the impairment of a long-lived asset held and used, or held for disposal other than by sale, whenever events or changes in circumstances indicate the carrying amount of the asset may not be recoverable. Therefore, entities are not required to routinely assess all of their long-lived assets for impairment. The following examples of events or circumstances that may indicate that an asset's carrying amount is not recoverable (FASB ASC 360-10-35-21):

- The market value of the asset significantly decreases.
- A significant adverse change in the physical condition of the asset or an adverse change in the way the asset is being used.
- A significant adverse change in legal factors or the business climate that could affect the value of the asset (e.g., actions or assessments by regulators).
- Incurring costs to acquire or construct an asset that are significantly higher than originally planned.
- Current period operating or cash flow losses along with a history of such losses or projections or forecasts of continuing losses related to use of the asset.
- A current expectation that the asset will likely be sold or disposed of significantly prior to the end of its estimated useful life (e.g., more than 50%).

PPC's Guide to Preparing Financial Statements provides detailed guidance on this topic. For order information, call (800) 261-4502 or go to **tax.thomsonreuters.com**.

Omission of Deferred Taxes. Another common problem with historical cost presentations is the omission of deferred taxes on the difference between the tax basis of an asset and its historical cost. For example, an individual may record the historical cost of an investment in oil and gas properties as the original cost, including capitalized intangible development cost (IDC) adjusted for depletion. However, on the individual's tax return, usually the individual has elected to deduct all IDC when incurred, not over the depletable life of the property. Deferred taxes on the difference between the tax and historical cost basis of the properties would be calculated and recorded in the historical cost basis personal financial statements.

The CPA Prepares His Own Personal Financial Statements

An interesting question not specifically addressed in authoritative literature arises if a CPA prepares his own personal financial statement. For example, he might submit a statement of his assets and liabilities or fill out a prescribed form in applying for a home mortgage or personal bank loan. Would the CPA be required to follow authoritative accounting or reporting standards in such a situation? Would he be held to higher standards of presentation or disclosure than others just because he is a CPA? Would the AICPA independence rules apply?

The AICPA *Code of Professional Conduct* (the AICPA Code) does not contain direct guidance. However, this course suggests that the CPA would not be required to report in any manner on his own financial statements, nor would he be held to a higher standard of accuracy or disclosure than would a non-CPA. In the situations described, the CPA would be acting as a primary issuer and not as an outsider engaged in the practice of public accounting. Public practice is defined in the AICPA Code at ET 0.400.42. That definition states that public practice involves the performance of professional services *for a client*. This supports the opinion stated in this course that the CPA is not practicing public accounting when he prepares his own financial statement, and thus, reporting, performance, and independence standards would not apply. Of course, the CPA would be held to whatever responsibilities apply to an ordinary citizen or primary issuer in the circumstances.

SELF-STUDY QUIZ

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

23. What is the correct term for a person who receives a future interest in property after a trust terminates?

    a. Beneficiary.

    b. Grantor.

    c. Income beneficiary.

    d. Remainderman.

24. Under which of the following circumstances would the carrying amount of a long-lived asset likely be unrecoverable?

    a. Market value on the asset increases.

    b. A substantial adverse change in the business climate affecting the asset's value.

    c. There is a 25% chance that the asset will be sold.

    d. The physical condition of the asset is unchanged over several years.

SELF-STUDY ANSWERS

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

23. What is the correct term for a person who receives a future interest in property after a trust terminates? **(Page 348)**

    a. Beneficiary. [This answer is incorrect. A *beneficiary* is an individual who is lawfully entitled to receive proceeds from a property held in trust, but the title to the trust property is vested in another, such as a trustee.]

    b. Grantor. [This answer is incorrect. The definition of a *grantor* is the person who establishes the trust. They can also be called *creator*, *donor*, *settlor*, or *trustor*.]

    c. Income beneficiary. [This answer is incorrect. An *income beneficiary* is defined as an individual who receives the income from the trust property while the trust is in effect.]

    d. Remainderman. [This answer is correct. A *remainderman* (also known as a *corpus beneficiary*) is an individual designated to receive a future interest in property at the termination of a trust.]

24. Under which of the following circumstances would the carrying amount of a long-lived asset likely be unrecoverable? **(Page 354)**

    a. Market value on the asset increases. [This answer is incorrect. The carrying amount would likely not be recoverable if the market value of the long-lived asset *decreases*, per FASB ASC 360-10-35-21.]

    b. A substantial adverse change in the business climate affecting the asset's value. [This answer is correct. According to FASB ASC 360-10-35-21, a significant adverse change in legal factors or business climate that could affect the value of the asset may indicate the asset's carrying value is not recoverable.]

    c. There is a 25% chance that the asset will be sold. [This answer is incorrect. According to FASB ASC 360-10-35-21, if the current expectation is that there is *more than a 50% chance* that the asset will likely be sold or disposed of significantly prior to the end of its estimated useful life, the carrying amount could be considered not recoverable.]

    d. The physical condition of the asset is unchanged over several years. [This answer is incorrect. Under FASB ASC 360-10-35-21, one indication that the carrying amount will not be recovered is a *significant adverse change* in the physical condition of the asset or an adverse change in the way the asset is being used.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Compilation and Review Engagements—Course 3—Interim Engagements, Special Purpose Frameworks, and Personal Financial Statements (CARTG173)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $89 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     CARTG173 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail).

Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $254 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $320 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $378 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked by **July 31, 2018**. CPE credit will be given for examination scores of 70% or higher.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Compilation and Review Engagements—Course 3—Interim Engagements, Special Purpose Frameworks, and Personal Financial Statements (CARTG173)

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

1. Should a firm's quality control system cover compilations and reviews of interim financial statements?

   a. Yes, because interim engagements are subject to peer review.

   b. Yes, because interim engagements are held to a higher documentation standard than year-end engagements.

   c. No, because interim engagements are not held to the same documentation standard as year-end engagements.

   d. No, because peer reviewers are prohibited from looking at interim engagements.

2. During the first interim period, compiled financial statements are more likely to do which of the following than year-end statements?

   a. Be exempt from engagement quality control reviews.

   b. Comply with the majority of GAAP requirements.

   c. Include substantially all disclosures and a statement of cash flows.

   d. Include unique supplementary material.

3. Who takes responsibility for the appropriateness of the reports and overall engagement quality for an interim compilation engagement?

   a. An elected member of the engagement team.

   b. The engagement partner.

   c. A senior partner in the firm not involved with the engagement.

   d. The client's management.

4. When performing an interim review engagement, how should the accountant establish an understanding with management?

   a. An oral understanding is sufficient for an interim review engagement.

   b. A written engagement letter signed only by the accountant or accountant's firm is sufficient for interim review engagements.

   c. An engagement letter should be written and signed by both parties for the first interim review engagement.

   d. Written and signed engagement letters should be obtained for each interim review engagement.

5. If the SSARS are not applicable to an interim review engagement, which authoritative guidance applies?
   a. AR-C 60.
   b. ASU 2015-17.
   c. AU-C 930.
   d. FASB ASC 270.
6. Harvest Fit has a seasonal business. Recognizing revenue when services are provided will distort its interim revenue. How should the company proceed?
   a. It should recognize revenue, both seasonal and otherwise, only at the end of its fiscal year.
   b. It should recognize revenue the same way, but disclose the seasonal nature of the business.
   c. It should use an alternate revenue recognition method for the interim period to avoid distortion.
   d. It should consult the users of the interim financial statements and use the revenue recognition method that will be of the most use to them.
7. When would the gross profit method typically be used to estimate inventory value?
   a. When physical counts cannot be made.
   b. When LIFO calculations are too time-consuming.
   c. When the inventory will be liquidated.
   d. When a standard cost system is used.
8. In the current interim period, Mac-2 suffers from inventory shrinkage. How should the related costs and expenses be treated?
   a. They should be deferred within the fiscal year.
   b. They should be accrued or deferred at the annual reporting date.
   c. They should be estimated and assigned to the interim periods.
   d. They should be charged to the interim period in relation to inventory sales.
9. What is the basic premise of interim financial reporting?
   a. It is more cost effective to calculate items as they occur.
   b. Though not integral to the annual period, interim periods provide supplementary information.
   c. It helps eliminate fraud and error because the information is looked at more often.
   d. Annual results should be allocated to interim periods.
10. Which of the following is the first step in calculating an interim tax provision?
    a. Estimating the current income tax provision for the year.
    b. Estimating the taxable temporary differences.
    c. Estimating the annual tax rate.
    d. Calculating the deferred income tax provision for the year.

11. Disclosure of which of the following is required for interim income tax provisions?

    a. Reasons for significant variations in the relationship between pretax accounting income and income tax expense.

    b. Current and deferred components of the entity's interim income tax provision.

    c. Differences between how operating loss carryforwards are treated in the interim statements and in the annual statements.

    d. Information about any newly enacted laws that affect the estimated deferred income tax provision.

12. Which of the following entities has experienced an event that would be classified as unusual, infrequent or both?

    a. SmallCo depreciates intangible assets.

    b. LittleCo moves into a new office in a different state.

    c. LargeCo recognizes a loss from sold equipment used in its business.

    d. MegaCo cancels a short-term rental contract.

13. Conrad is preparing the second-quarter financial statements of a new client. He discovers that the first-quarter statements included income tax expense that was computed on income-to-date instead of using an estimated annual effective rate. This is an example of which of the following?

    a. A change in accounting estimate.

    b. A change in reporting entity.

    c. A change in accounting principle.

    d. An error in a prior period.

14. The decision of whether to report the effect of an accounting change or error correction in interim financial statements is based on which of the following?

    a. Income for the entire fiscal year and the effect on the earnings trend.

    b. Income in the interim period and the frequency with which such events occur.

    c. Income in the interim period and the effect on the earnings trend.

    d. The frequency with which such events occur and the income for the entire fiscal year.

15. Which of the following should be disclosed in a nonpublic entity's interim financial statements?

    a. The unchanged accounting policies used by the entity.

    b. Immaterial adjustments made to reconcile physical inventory.

    c. Details about material costs that are readily identified with specific activities of other interim periods.

    d. Use of the gross profit method for valuing inventory in the interim period.

16. What is the determining factor for whether reporting requirements apply to an interim engagement?

    a. Whether a special purpose framework was used.

    b. Whether the accountant was engaged for preparation, compilation, or review services.

    c. Whether any accounting changes occurred during the interim period.

    d. Whether standardized reports will be used.

17. Under what circumstances might an accountant provide draft financial statements to his or her client?

    a. The client needs its twelfth-month statements before a higher level of service can be completed.

    b. The client's management has determined that use of a special purpose framework is appropriate.

    c. The prior period financial statements will need to be adjusted for the correction of an error.

    d. A change in accounting principle requires that all prior period financial statements be restated.

18. Which of the following terms is included in the definition sections of AR-C 70, AR-C 80, and AR-C 90 and describes a financial reporting framework other than GAAP?

    a. Generally accepted accounting procedures.

    b. International Finanical Reporting Standards (IFRS).

    c. An other comprehensive basis of accounting (OCBOA).

    d. A special purpose framework.

19. Which of the following entities is most suited to use of the modified cash basis?

    a. TinyCo has extremely simple operations.

    b. DailyCo is cash oriented and does not have significant financing or complexities.

    c. BusyCo reports its financial results to third parties.

    d. The cost of converting ProfitCo's financial statements to GAAP would exceed the benefits.

20. Which of the following statements best describes use of the tax basis?

    a. If the accrual basis is used, it will be cost prohibitive for the entity to prepare GAAP financial statements; therefore, the tax basis is preferable.

    b. Tax law may allow special accounting treatments that would not be permissible in either GAAP or cash basis financial statements.

    c. Any modifications made to the tax basis of accounting would need to have substantial support and not be illogical.

    d. When the tax basis is used, revenues and expenses will be recognized based on the receipt and disbursement of cash.

21. This year, Orchid House presents its financial statements using the tax basis of accounting instead of GAAP. Zach is engaged to review Orchid House's financial statements for the current year. Which of the following pieces of advice should Zach use in this engagement?

    a. Orchid House's use of the tax basis should be considered a change in accounting principle.

    b. Authoritative guidance requires that Orchid House's change be disclosed in the financial statement.

    c. If the change is disclosed in the financial statements, Zach could add an emphasis-of-matter paragraph to his report.

    d. Zach is prohibited from adding an other-matter paragraph to his report about Orchid House's use of the tax basis.

22. Special purpose financial statements are prohibited from including which of the following under AU-C 800, Appendix B, *Fair Presentation and Adequate Disclosure*?

    a. Balance sheet.

    b. Statement of cash flows.

    c. Statement of changes in stockholder's equity.

    d. Statement of retained earnings.

23. If an entity that uses a special purpose framework presents both the results of operations and financial position, it is a best practice for which of the following to also be included?

    a. Changes in the components of stockholder's equity.

    b. Changes in retained earnings.

    c. Comprehensive income.

    d. A statement of cash flows.

24. How should captions be treated in financial statements prepared using a special purpose framework?

    a. Accountants are required by the SSARS to modify captions so they differ from those in GAAP financial statements.

    b. Accountants are not required to modify captions from those used in GAAP statements, but they can if they desire.

    c. Accountants must modify captions used in GAAP statements if the pure cash or tax bases are used, but not under other special purpose frameworks.

    d. Accountants are required to use the same captions for items that are found in GAAP financial statements.

25. Which of the following statements most accurately describes disclosures made in special purpose financial statements?

    a. It is not appropriate to make the same disclosures that are required by GAAP because users might mistake the statements for a GAAP presentation.

    b. It is necessary to quantify and disclose the differences between the special purpose framework and GAAP.

    c. The financial statements need to include a description of the financial reporting framework, differences from GAAP, and a summary of the significant accounting policies used.

    d. Additional disclosures should be avoided because it might impact the fair presentation of the financial statements.

26. Mecha Motors prepares its financial statements using GAAP, but reports on the cash basis for income tax purposes. Including which of the following might be helpful under these circumstances?

    a. A representation letter.

    b. A disclosure of comprehensive income.

    c. A summary of significant accounting policies.

    d. A cash to accrual conversion.

27. Tyrone is engaged to review a business that presents its financial statements using a special purpose framework. Tyrone needs to obtain which of the following specific to this type of engagement?

    a. An engagement letter.

    b. A representation letter.

    c. A cash to accrual conversion.

    d. A description of the basis of accounting.

28. The financial statements that present an individual or family's personal assets and liabilities are called what?

    a. Historical financial statements.

    b. Interim financial statements.

    c. Personal financial statements.

    d. Special purpose financial statements.

29. What title is typically used for the basic personal financial statement?

    a. Balance Sheet.

    b. Statement of Financial Condition.

    c. Statement of Changes in Net Worth.

    d. Statement of Retained Earnings.

30. How often would a statement of changes in net worth typically be presented as part of personal financial statements?

    a. Always, because it is required by professional standards.

    b. Often, because it is typically requested by creditors.

    c. Rarely, because it is not usually needed by creditors.

    d. Never, because it is prohibited by professional standards.

31. Which of the following individuals has correctly dealt with an issue related to his or her personal financial statements?

    a. Alejandro includes valuable pieces of art in his financial statements.

    b. Brianna presents assets and liabilities at the values they had when she acquired them.

    c. Christian nets the assets and liabilities of a limited business activity not conducted as a separate entity.

    d. Delia records her future social security benefits as an asset.

32. What is the most preferred method for estimating current value?

    a. Using recent transactions involving similar items in similar circumstances.

    b. Capitalizing the item's past or prospective earnings.

    c. Using liquidation value for the item.

    d. Using discounted amounts of projected cash receipts and payments.

33. Which of the following statements best describes a personal financial statement engagement?

    a. This type of engagement generally requires less interaction with the client than other engagements.

    b. Engagement letters are required for reviews of personal financial statements but not compilations.

    c. The accountant can provide additional accounting services if the client's records are not adequate.

    d. It is easier to determine the tax basis of an individual's assets and liabilities than it is to do so for a business entity.

34. Hal is engaged to review his client's personal financial statements. Which of the following additional sources will provide Hal information about his client's cash balance?

    a. Income tax returns.

    b. Lists of contents of safe-deposit boxes.

    c. Wills and leases.

    d. Checkbooks and bank statements.

35. When performing a review of personal financial statements, the accountant's experience with and inquiries of the client will provide knowledge about which of the following?

    a. How AR-C 90 applies apply to the review of personal financial statements.

    b. What information appears in the client's financial statements.

    c. The nature of assets and liabilities and the sources of income.

    d. Information to identify relationships and unusual estimated current value.

36. Which of the following accountants have addressed an issue related to reporting on compiled or reviewed personal financial statements using the best practice recommended in this course?

    a. Evan includes an emphasis-of-matter paragraph in his report outlining a small uncertainty in the estimated current value of an asset.

    b. Francine's report matches that used for commercial entities in form and substance except for a few subtle differences, such as identifying her client as an individual.

    c. Gregory modifies his report for a scope limitation due to his client's lack of available accounting records.

    d. Holly's client has a measurement departure from GAAP; she mentions it in a separate paragraph in her report and includes the dollar effect.

37. How does the AR-C 60.26C requirement about internal control over financial reporting apply to personal financial statements?

    a. The requirement applies to this type of engagement; therefore, the accountant should expect to see a system of internal control that is just as sophisticated as that of a business entity.

    b. The requirement applies to this type of engagement even though the controls are less sophisticated. The individual should, for example, be aware of its assets and liabilities.

    c. The requirement does not apply fully to this type of engagement; therefore, with appropriate documentation of the justification, the accountant's consideration of internal control will be superficial.

    d. The requirements does not apply since the client is not a business; therefore the accountant is exempt from considering internal control in this type of engagement.

38. How many income tax liabilities are included in personal financial statements?

    a. None.

    b. One.

    c. Two.

    d. Three.

39. Donald is engaged to prepare personal financial statements for Joe, an individual with significant net worth. The financial statements will be used for a loan guarantee. Joe would like to show a minimum of net worth for security reasons, but he does not want to mislead any users. What method does the course recommend to best help Joe in this situation?

    a. Omitting assets from his financial statements entirely.

    b. Valuing certain assets at cost instead of at the current estimated value.

    c. Presenting Joe's financial statements using a special purpose framework, such as the historical or tax basis.

    d. Using any method to reduce Joe's net worth would be misleading, so Donald cannot offer any alternatives and still be incompliance with SSARS.

40. How would CPAs preparing their own personal financial statements be treated in comparison to a non-CPA?

    a. Because of their advanced knowledge of financial statements, CPAs will be held to a higher standard than regular individuals.

    b. Because it is in their capabilities, CPAs are required to accompany their personal financial statements with a compilation or review report.

    c. Because they are the primary issuer, CPAs are not practicing public accounting in this instance, so are held to the same responsibilities as regular individuals.

    d. Because of their experience with financial statements, CPAs are allowed to take more shortcuts in their personal financial statements than those allowed for regular individuals.

GLOSSARY

Accounting changes: Changes in accounting principle, changes in accounting estimate, and changes in reporting entity. *Error* corrections are not included.

AICPA's *Financial Reporting Framework for Small- and Medium-Sized Entities* (*FRF for SMEs* or Framework): This is a new, optional reporting framework that provides another GAAP-alternative for small businesses. However, unlike other common *special purpose frameworks*, the FRF for SMEs accounts for an entity's transactions according to their economic substance, which is the same objective as GAAP. The FRF for SMEs is not authoritative. It fits the definition of the *other basis* type of special purpose framework.

Beneficiary: An individual who is lawfully entitled to receive proceeds from property held in trust, but the title to the trust property is vested in another, such as a *trustee*.

Cash basis: A basis of accounting that the entity uses to record cash receipts and disbursements, including modifications of the basis that have substantial support. When the *pure cash basis* is modified, some call this the *modified cash basis*, while others just call it *cash basis*.

Change in accounting principle: When an entity changes from one generally accepted accounting principle to a different generally accepted accounting principle when two or more generally accepted accounting principles could apply or when the accounting principle previously used us no longer generally accepted.

Component of an entity: The operations and cash flows of an entity that can be clearly distinguished from the rest of the entity, such as a reportable segment, an operating segment, a reporting unit, a subsidiary, or an asset group.

Comprehensive income: Net income and the components that make up *other comprehensive income* (i.e., certain revenues, expenses, gains, and losses that are reported as separate components of stockholders' equity rather than net income).

Contractual basis: A basis of accounting used by an entity to comply with an agreement between the entity and one or more third parties other than the accountant.

Errors: In financial statements, errors include mathematical mistakes, mistakes in the application of accounting principles, and the oversight or misuse of facts that existed at the time that the financial statements were prepared.

Estimated current value: The amount at which the item could be exchanged between a buyer and a seller, each of whom is well informed and willing, and neither of whom is compelled to buy or sell.

Estimated future tax: An estimated tax on the difference between the estimated current value of assets and the estimated current amounts of liabilities and their tax bases.

FIFO (first in, first out): An accounting method for dealing with inventory in which the first piece of inventory in is the first piece out.

Future interests: Nonforfeitable rights to receive future sums.

Grantor: The person who establishes a trust. Also called creator, donor, settlor, or trustor.

Historical cost basis: A basis of accounting that generally measures an individual's assets and liabilities in accordance with GAAP for reporting entities other than individuals. This basis of accounting is associated with *personal financial statements*.

Income beneficiary: An individual who receives the income from the trust property while the trust is in effect.

Interim financial statements: Financial statements that cover a period of less than one year.

***Inter vivos* trust:** A trust created during the creator's lifetime.

LIFO (last in, first out): An accounting method for dealing with inventory in which the last piece of inventory in is the last piece of inventory out.

Net worth: The difference between assets and liabilities after deducting the provision for estimated income taxes on the differences between the estimated current values of assets and estimated current amounts of liabilities and their tax bases.

Ordinary income (or loss): Income (or loss) from continuing operations before income taxes (or benefits) excluding significant unusual or infrequently occurring items.

Other basis: A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material financial statement items.

Other comprehensive basis of accounting (OCBOA): This term was superseded by the term *special purpose framework*. However, *OCBOA* is still commonly used to refer to the cash basis, tax basis, regulatory basis, and other basis of accounting.

Other comprehensive income: This element of *comprehensive income* is made up of (1) unrealized gains and losses on debt and equity securities classified as available-for-sale, (2) gains or losses related to pension or other postretirement benefits, (3) prior service costs or credits related to pension or other postretirement benefits, (4) transition assets or obligations related to pension or other postretirement benefits, (5) foreign currency translation adjustments and gains and losses from certain foreign currency transactions, and (6) the effective portion of the gain or loss on derivative instruments designated as cash flow hedging instruments.

Personal effects: Items such as objects of art, jewelry, and household furnishings.

Personal financial statements: Financial statements that present the personal assets and liabilities of an individual or group of related individuals (a family). This term does not include financial statements presenting the financial position or results of operations of unincorporated business enterprises, such as proprietorships or partnerships.

Pure cash basis: All disbursements of cash are treated as expenses; thus, the purchase of property and equipment or inventory is recognized as an expense rather than as an asset. The balance sheet only contains cash and equity, and the income statement reflects all cash receipts as revenues and all cash disbursements as expenses.

Regulatory basis: A basis of accounting that the entity uses to comply with the requirements (or financial reporting provisions) of a regulatory agency to whose jurisdiction the entity is subject.

Remainderman (or corpus beneficiary): The individual(s) designated to receive a future interest in property at the termination of the trust.

Small- and medium-sized entity (SME): In relation to the FRF for SMEs, SMEs include the following characteristics: (1) they are not required to prepare GAAP-based financial statements, (2) they have no plans to go public in the foreseeable future, (3) they are for-profit entities, (4) the owners are also the people who run the entities, (5) there is no highly specialized accounting guidance for the industry in which the entities operate, (6) they have no overly complicated transactions, (7) they have no significant foreign operations, and (8) users of their financial statements have direct access to management.

Special purpose framework: A financial reporting framework other than GAAP that is one of the following bases of accounting: (1) cash basis, (2) tax basis, (3) regulatory basis, (4) contractual basis, or (5) other basis. This term has replaced the term *other comprehensive basis of accounting (OCBOA)*.

Substantial support: A modification to the *pure cash basis* is classified thus if it is equivalent to GAAP for a particular item and if all modifications taken together are not illogical.

Tax basis: A basis of accounting used by an entity to file its tax return for the period covered by the financial statements.

Testamentary trust: A trust set up in a will that becomes effective after death.

Trustee: A person who holds legal title to property in a fiduciary capacity for the benefits of others (*beneficiaries*) pursuant to a written trust instrument.

INDEX

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Compilation and Review Engagements—Course 1—Form and Presentation of Financial Statements, Partnerships, and S Corporations (CARTG171)

Name: ______________________________

Firm Name: ______________________________

Firm Address: ______________________________

City: ______________________________ State /ZIP: ______________________________

Firm Phone: ______________________________ Firm Fax No.: ______________________________

Firm Email: ______________________________

Signature: ______________________________

Credit Card Number: ______________________________ Expiration Date: ______________________________

Birth Month: ______________________________ Licensing State: ______________________________

ANSWERS:

Please indicate your answer for each question by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ✓ .

You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Expiration Date: July 31, 2018

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Compilation and Review Engagements—Course 1—Form and Presentation of Financial Statements, Partnerships, and S Corporations

Course Acronym: CARTG171

Your Name (optional): ______________________ Date: ______________________

Email: ______________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. ______________

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Compilation and Review Engagements—Course 2—Engagement Administration (CARTG172)

Name: ____________________

Firm Name: ____________________

Firm Address: ____________________

City: ____________________ State /ZIP: ____________________

Firm Phone: ____________________ Firm Fax No.: ____________________

Firm Email: ____________________

Signature: ____________________

Credit Card Number: ____________________ Expiration Date: ____________________

Birth Month: ____________________ Licensing State: ____________________

ANSWERS:

Please indicate your answer for each question by filling in the appropriate circle as shown: Fill in like this ● not like this ⃠ ⊗ ✓.

You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Expiration Date: July 31, 2018

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Compilation and Review Engagements—Course 2—Engagement Administration

Course Acronym: CARTG172

Your Name (optional): ______________________ Date: ______________

Email: ______________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
	Low (1) . . . to . . . High (10)									
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. ____________

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Compilation and Review Engagements—Course 3—Interim Engagements, Special Purpose Frameworks, and Personal Financial Statements (CARTG173)

Name: ______________________________

Firm Name: ______________________________

Firm Address: ______________________________

City: ______________________________ State /ZIP: ______________________________

Firm Phone: ______________________________ Firm Fax No.: ______________________________

Firm Email: ______________________________

Signature: ______________________________

Credit Card Number: ______________________________ Expiration Date: ______________________________

Birth Month: ______________________________ Licensing State: ______________________________

ANSWERS:

Please indicate your answer for each question by filling in the appropriate circle as shown: Fill in like this not like this .

You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Expiration Date: July 31, 2018

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Compilation and Review Engagements—Course 3—Interim Engagements, Special Purpose Frameworks, and Personal Financial Statements

Course Acronym: CARTG173

Your Name (optional): ______________________ Date: ______________

Email: ______________________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. ____________

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

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5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

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