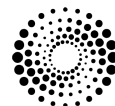


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SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Cash, Tax, and Other Bases of Accounting



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Interactive Self-study CPE
Companion to PPC's Guide to
Cash, Tax, and Other Bases of Accounting

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INTRODUCTION

Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting consists of two interactive self-study CPE courses. These are companion courses to *PPC's Guide to Cash, Tax, and Other Bases of Accounting* 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 **November 30, 2018**. Complete instructions for grading 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 financial statements prepared on an other comprehensive basis of accounting (also known as a special purpose framework). 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 record your answer choices by printing the **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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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.

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For all scores of 70% or higher, you will receive a *Certificate of Completion*. You should retain it and a copy of these materials for at least five years.

COMPANION TO PPC'S GUIDE TO CASH, TAX, AND OTHER BASES OF ACCOUNTING**COURSE 1****OTHER BASES OF ACCOUNTING, REPORTING ON SPECIAL PURPOSE FRAMEWORK FINANCIAL STATEMENTS, AND INTERIM ENGAGEMENTS (OFSTG171)****OVERVIEW**

COURSE DESCRIPTION: This interactive self-study course provides an introduction to preparing and reporting on financial statements using other comprehensive bases of accounting. The course discusses general and specific considerations that should be taken into account while using other comprehensive bases of accounting, and applies those considerations to disclosures and reporting requirements.

PUBLICATION/REVISION DATE: November 2017

RECOMMENDED FOR: Users of *PPC's Guide to Cash, Tax, and Other Bases of Accounting*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of accounting

CPE CREDIT: 8 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 **November 30, 2018**

KNOWLEDGE LEVEL: Basic

Learning Objectives:**Lesson 1—Other Bases of Accounting**

Completion of this lesson will enable you to:

- Identify the general reporting considerations for the regulatory and contractual and other basis of accounting and determine how compilation and review reports are affected by these bases of accounting.

Lesson 2—Reporting on Special Purpose Framework Financial Statements

Completion of this lesson will enable you to:

- Identify the required elements of compilation and review reports, how accountants deal with compilation reports when they lack independence, when financial statements omit substantially all disclosures, or when there are material measurement departures.
- Determine how accountants should use the various emphasis paragraphs in compilation and review reports.
- Recognize how modifications are made to the auditor's standard reports.

- Identify how auditors report on regulatory basis financial statements as special purpose framework financial statements.
- Recognize how auditors prepare personal financial statements using the various bases of accounting.

Lesson 3—Interim Engagements

Completion of this lesson will enable you to:

- Identify unique issues in preparing interim financial statements using a special purpose framework and reporting on those statements.

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Lesson 1: Other Bases of Accounting

INTRODUCTION

Interpretation 14 of SAS No. 62, issued in January 1998, was initially designed to provide guidance for only three comprehensive bases of accounting other than GAAP—pure cash basis, modified cash basis, and income tax basis. Those were the bases of accounting, other than GAAP, for which accountants who worked with small and midsize nonpublic entities consistently asked for guidance. That situation remains unchanged and, accordingly, those bases of accounting continue to be the focus of this Course. This lesson considers special purpose frameworks other than the cash, modified cash, and income tax bases.

Additional types of accounting bases mentioned in the auditing and compilation and review authoritative literature include regulatory basis, contractual basis, and other basis. Those bases are defined at AU-C 800.07, AR-C 70.07, AR-C 80.05, and AR-C 90.05, and are discussed later in this lesson.

Learning Objectives:

Completion of this lesson will enable you to:

- Describe the general reporting considerations for the regulatory and contractual and other basis of accounting and determine how compilation and review reports are affected by these bases of accounting.

Other Bases

Over the years, many accountants have questioned if any other bases of accounting could be considered appropriate for use. Below is a list of those that have most commonly been considered as possible other financial reporting frameworks—

- *Fair Value Basis.* Using the definition in FASB ASC 820-10-20, *fair value* is “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.”
- *Liquidation Basis.* The liquidation basis of accounting presents assets at amounts expected to be realized in liquidation and liabilities at amounts expected to be paid to creditors.
- *Historical Cost Basis Personal Financial Statements.* Personal financial statements presented in accordance with GAAP measure assets and liabilities at their estimated current values and amounts, rather than at their historical costs.

Considerations for determining whether the fair value or liquidation bases meet authoritative criteria for treatment as a special purpose framework is discussed further later in this lesson.

REGULATORY BASIS

Regulated companies are required to report financial information to the federal, state, or local government agencies that regulate them. Often, the basis of accounting used to report to those agencies (referred to as the regulatory basis) differs from GAAP because of unique reporting requirements related to the regulatory process. For example, to obtain information about an insurance company's ability to pay claims in the future, a state regulatory agency may require insurance companies to report certain balance sheet accounts on a liquidation basis rather than on a going concern basis.

Regulatory basis financial statements are prepared by many types of entities, such as the statutory accounting practices used by insurance companies pursuant to the rules of state insurance commissions, the regulatory accounting practices used by certain small credit unions (i.e., less than \$10 million in assets), and the basis used by contractors in submitting state prequalification reports as a condition for bidding or working on government projects. Additionally, certain state and local governmental entities and some nonprofit organizations may use the regulatory basis.

Disclosure Considerations for the Regulatory Basis

AU-C 800.18b, AR-C 80.20b, and AR-C 90.42b provide disclosure guidance specific to regulatory basis financial statements that requires a reference to a note in special purpose financial statements describing the purpose for which the financial statements are prepared or a description of that information in the auditor's or accountant's report. Thus, the accountant has a choice of where to present the information. AU-C 800.A24, AR-C 80.A27, and AR-C 90.A81 indicate that such information is necessary to avoid misunderstandings when the special purpose financial statements are used for purposes other than for what they were intended.

Reporting on Regulatory Basis Financial Statements

See the discussion in lesson 2 about the requirements under AU-C 800 and the SSARS for reporting on regulatory basis financial statements.

Statutory Accounting Practices Used by Insurance Companies

The basis of accounting used by an insurance company for filing financial reports with a state regulatory authority is one of the most common examples of the regulatory basis of accounting. Regulatory authorities in each state generally require insurance companies licensed to do business in the state to file with the state insurance commissioner an Annual Statement (which presents the company's financial information as of December 31 of the current and preceding year) and audited statutory basis financial statements. The statements are prepared using statutory accounting principles (SAP), which vary between states. SAP currently consists of the accounting principles and practices prescribed by each state's regulatory authority. SAP also include permitted practices allowed by each state regulatory authority, resulting in permitted practices that may differ from state to state, as well as from company to company within a state.

Primary Differences between GAAP and SAP. The primary emphasis of SAP is on demonstrating the solvency (i.e., the ability to pay claims in the future) of insurance companies to state regulators. Consequently, SAP financial statements present many balance sheet accounts on a liquidation basis rather than a going concern basis. Differences between GAAP and SAP are discussed in the AICPA Audit and Accounting Guides, *Property and Liability Insurance Entities*, and *Life and Health Insurance Entities*.

Disclosures in Statutory Financial Statements. A state's statutory basis of accounting will include the extensive disclosures appropriate for the basis of accounting required by the particular state's codified statutory accounting principles.

Reporting on Audited Statutory Financial Statements. As discussed in lesson 2, the appropriate form of regulatory basis report depends on the use of the reports. If an insurance company's statutory financial statements will be used solely for filing with state regulatory authorities to whose jurisdiction the company is subject, AU-C 800 allows auditors to report on the statutory statements as special purpose financial statements. In that case, the auditor's report should contain a statement that restricts the use of the statutory basis financial statements to those within the insurance company and for filing with the state regulatory authorities to whose jurisdiction the company is subject. If an insurance company's statutory financial statements are intended for use other than for filing with the state regulatory authorities to whose jurisdiction the company is subject, AU-C 800 requires auditors to modify the standard form of auditor's report prescribed by AU-C 700 and AU-C 800 for any material GAAP departures relating to the statutory basis. After expressing a modified opinion as to conformity with GAAP, auditors may express an opinion on whether the statements are presented in conformity with statutory accounting practices.

The AICPA Guides listed previously in the paragraph titled **Primary Differences between GAAP and SAAP** provide further insurance specific guidance on applying reporting requirements to audited statutory basis financial statements filed with state regulatory authorities.

Regulatory Accounting Practices Used by Financial Institutions

Banks and savings institutions follow GAAP. However, small credit unions (those with less than \$10 million in assets) have the option of presenting their financial statements using regulatory accounting practices (RAP).

The AICPA Audit and Accounting Guide, *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies*, provides information on some of the differences between GAAP and RAP for credit unions. Additionally, *PPC's Guide to Audits of Financial Institutions* provides certain limited information about regulatory accounting practices used by financial institutions.

Construction Contractors

A contractor may be required to submit prequalification filings with certain government agencies to qualify for bidding on or performing work for the agency. The prequalification filings generally request that contractors provide GAAP financial information; however, the filings often prescribe preprinted forms that do not conform with professional standards either as to the accountant's report or the financial information. Best practices indicate that GAAP basis financial statements that do not include all of the financial statement disclosures required by GAAP because the regulations do not require the disclosures cannot be considered regulatory basis financial statements. Such statements are GAAP basis financial statements and should be reported on accordingly.

In the unusual situation where a state develops detailed accounting requirements that are not in accordance with GAAP, financial statements prepared following those requirements may be considered as prepared on a regulatory basis of accounting.

Regulatory Basis May Be GAAP

As discussed in the previous paragraphs, the financial statements of certain regulated companies may differ from GAAP. However, many other regulated operations are covered by GAAP. For example, the guidance in FASB ASC 980 applies to most public utilities and other enterprises that have regulated operations and meet the criteria specified by FASB ASC 980-10-15-2.

FASB ASC 980 provides guidance on and accounting for certain aspects of regulated entities. The accounting specified in the FASB ASC for a regulated entity is GAAP for that particular entity, even though such accounting may not be GAAP for nonregulated entities. Therefore, if a regulated entity's financial statements are prepared using the accounting principles specified by GAAP, that entity's financial statements should be considered GAAP rather than regulatory basis statements.

CONTRACTUAL AND OTHER BASES OF ACCOUNTING

Contractual Basis

The contractual basis generally is a basis of accounting that is required by a contract or other agreement and does not comply with GAAP, the cash basis, the income tax basis, or the regulatory basis. Some examples of contractual basis situations follow—

- An offer to buy some of the assets of an entity and assume some of its liabilities may require a statement of those assets and liabilities as of a prescribed date. The offer prescribes that the assets and liabilities should be measured using GAAP. The prescribed basis would nevertheless depart from GAAP because it only reports some of the assets and liabilities of the entity.
- An offer to buy the equity interests of an entity may require a statement of financial position prepared using tax positions the entity presently uses and tax positions the potential acquirer is considering electing if it acquires the entity. The financial statement would not be an income tax basis statement because it does not reflect tax positions the entity uses to file its income tax return.
- A personal services corporation has a buy-out agreement with its majority stockholder that requires a statement of financial position prepared using the cash basis the corporation uses for tax reporting modified to recognize all receivables that are less than 90 days old and to recognize work-in-process that is likely to be realized. The financial statement would not be an income tax basis statement because it does not reflect tax positions the corporation uses to file its income tax return.
- An agreement to purchase the equity interest of the founder of an entity requires the entity to annually provide financial statements prepared using GAAP except that the entity's real estate is to be measured

at its fair value and its inventory is to be measured at replacement cost instead of LIFO, which the entity uses to report to banks and vendors.

The measurement principles depend entirely on the terms of the contract. However, depending on the facts and circumstances, interpretation may be needed. To illustrate, assume that a loan agreement requires financial statements prepared using “standard accounting principles with all real estate shown at market value.” Two interpretations would be needed:

- a. The phrase “standard accounting principles” is not well-known and would require interpretation. For example, it may reasonably be interpreted to mean “generally accepted accounting principles.”
- b. “Market value” is a vague term and would require interpretation. For example, it may reasonably be interpreted to mean “fair value determined using generally accepted accounting principles.”

Financial Statement Titles. Contractual basis financial statements should have titles that avoid any implication that the financial statements are presented in conformity with GAAP. Best practices suggest referring to the statements as “Contractual Basis Statements of . . .” or adding a description to the financial statement title such as “Statement of Revenues and Expenses Based on Accounting Called for by [Name of Contract].”

Audit Performance Considerations. AU-C 210.06 establishes preconditions for an audit. In accepting the engagement, the auditor is required by AU-C 800.10 to determine the acceptability of the basis of accounting (the financial reporting framework) and obtain an understanding of (a) the purpose for which the financial statements are prepared, (b) the intended users, and (c) the steps taken by management to determine that the applicable financial reporting framework is acceptable in the circumstances. In the case of contractual basis financial statements, the framework is ordinarily identified in the contract, implying that the specified users found the framework to be acceptable.

AU-C 800.11 provides further explanation of preconditions that apply to the audit of special purpose financial statements, indicating that the auditor is required to obtain management's agreement that it acknowledges and understands its responsibility to include all informative disclosures that are appropriate for the special purpose framework used. When the special purpose framework is the contractual basis, management should include with those disclosures a description of any significant interpretations of the contract on which the financial statements are based.

Additionally, AU-C 800.13 requires the auditor to obtain an understanding of any significant interpretations of the contract that management made in the preparation of the financial statements. An interpretation is considered to be significant when adopting some other reasonable interpretation would have caused a material difference in the information presented in the financial statements. Additionally, an auditor may determine that an interpretation is significant based on qualitative considerations.

The nature of the contractual basis may necessitate that the auditor modify certain procedures. For example, if the contractual basis requires that certain assets be stated at current replacement cost, the auditor may need to modify the audit procedures used to test asset valuation. In those situations, the auditor may need to use the work of a specialist to assess the appropriateness of asset values.

Disclosure Considerations for Audit Engagements. AU-C 800.16 requires that any significant interpretations of the contract be disclosed. An example of such a disclosure follows:

NOTE X—BASIS OF ACCOUNTING

The financial statements have been prepared on the basis of accounting required under the terms of a contract with the former majority equity holder. That agreement requires preparing the financial statements using accounting principles generally accepted in the United States of America, except that the operating and investment real estate are to be reported at their “market value” instead of their cost, adjusted for any accumulated depreciation, and the inventory is to be reported at its replacement cost instead of using the last-in, first-out method, which is the method the entity uses to report financial results to banks and vendors. “Market value” has been

interpreted to mean fair value determined using accounting principles generally accepted in the United States of America.

Compilation and Review Performance Considerations. AR-C 80.08(a)(ii) and AR-C 90.09(a)(ii) indicate that as a condition for accepting an engagement to compile or review an entity's financial statements prepared using a contractual basis of accounting, the accountant should obtain management's agreement that it acknowledges and understands its responsibility to provide a description of any significant interpretations of the contract on which the special purpose financial statements are based. (This condition on the acceptance of the engagement is virtually identical to the requirement in the auditing guidance that is discussed later in this lesson.) This agreement by management is one of several responsibilities that company management should acknowledge and understand before the accountant accepts a compilation or review engagement for financial statements prepared using a special purpose framework. The accountant establishes that understanding with management through a written communication.

Disclosure Considerations for Compilation and Review Engagements. AR-C 80.19 and AR-C 90.41 require the accountant to modify his or her compilation or review report if financial statements prepared using a contractual basis of accounting do not disclose significant interpretations of the contract. Also, the accountant's report should describe the purpose for which the contractual basis financial statements were prepared or refer to a note that does so (AR-C 80.20b and AR-C 90.42b).

Other Bases

AU-C 800.07 and the SSARS state that the *other basis* is a financial reporting framework other than GAAP that utilizes a definite set of logical and reasonable criteria that is applied to all material items included in the financial statements. Some possible other bases of accounting are listed earlier in this lesson. Consideration of whether fair value or liquidation basis is an other basis of accounting is addressed later in this lesson.

The AICPA's *Financial Reporting Framework for Small- and Medium-Sized Entities* (FRF for SMEs), qualifies as an other basis. This special purpose framework provides another GAAP-alternative for small businesses. While it uses historical cost as the primary measurement basis, it also includes some similarities to the accrual income tax basis. Although issued by the AICPA, the FRF for SMEs framework is not authoritative because it has not been acted upon, approved, or disapproved by any senior technical committee of the AICPA or FASB.

In July 2017, AICPA Technical Q&A 9160.34, "Accounting Standards as Promulgated by FASB as a Special Purpose Framework," was released and addresses the situation of whether a state or local government (or component) that is supposed to use accounting principles promulgated by GASB as its basis of accounting, can instead use the FASB ASC as an other basis framework. The AICPA is clear in its response of "No," stating that the definition of a special purpose framework, which includes the "other basis," is a financial reporting framework *other than GAAP*.

A select few other accounting bases have been discussed by accountants over the years as other possible financial reporting frameworks. The following information considers whether the use of comprehensive fair value measurements or liquidation basis qualifies as a special purpose framework.

Comprehensive Fair Value Measurements

Three sources of authoritative guidance on fair value measurements look at comprehensive application of fair value measurements, but each has a different perspective.

- a. FASB ASC 274-10, *Personal Financial Statements*, looks at the fair values of individual assets and liabilities and derives the net worth of an individual by subtracting the fair value of the liabilities from the fair value of the assets.
- b. FASB ASC 805, *Business Combinations*, requires an acquirer in a business combination to recognize and measure the identifiable assets acquired, liabilities assumed, and noncontrolling interests in the acquired entity at their fair values at the acquisition date, with limited exceptions.
- c. FASB ASC 810-10, *Consolidation*, estimates the fair value of the net assets of a variable interest entity without looking at individual assets and liabilities.

These different perspectives suggest the existence of a threshold question: What should net assets in a comprehensive application of fair values represent? Do they represent the fair value of the reporting entity or are they simply the residual of fair value measurements of individual assets and liabilities?

Guidance on measuring individual assets and liabilities at fair value is provided in the authoritative accounting literature. For example—

- a. FASB ASC 274-10 provides guidance on determining the fair values of assets and liabilities common to individuals.
- b. FASB ASC 820-10, *Fair Value Measurement*, provides a framework for measuring fair value.

Different methods are discussed, but the appropriate method depends on the facts and circumstances. For example, depending on the facts and circumstances—

- a. the fair value of some assets may be determined using quoted prices in an active market,
- b. the fair value of some assets may be determined by discounting forecasted cash flows, and
- c. the fair value of some assets may be determined using replacement cost.

The application of any of the available measurement methods often requires significant judgment. For example—

- a. Measurement based on discounted long-term cash flows requires developing assumptions about future sources of cash flows and the likelihood that those cash flows will be realized.
- b. Even if a market exists for real estate, the location may be subject to uncertain market conditions that affect the fair value of the property.

There is little authoritative guidance on determining the income tax effect of unrealized appreciation and depreciation. For example, should deferred taxes be measured assuming that the assets had been realized and the liabilities had been settled at the measurement date? That is the approach taken in FASB ASC 274-10 with regard to personal financial statements, but, while it may be a practical approach, it may not be a reasonable one because the entity may have tax-planning strategies that would defer the realization and settlement dates.

Entities considering comprehensive fair value measurements ordinarily are thinking about financial position. However, there is also the possibility of presenting results of operations using fair value measurements. That raises a variety of questions. For example, how should the entity report the change in unrealized appreciation and depreciation? Should the entity report the net change as a single line item and, if so, how should it be reported? Or should changes be allocated to components of results of operations?

The FASB appears to be cautiously moving toward providing guidance on a comprehensive application of fair values. It was not that long ago that fair value guidance generally was provided only in the context of impairment. The FASB has since moved to—

- a. The continuing measurement of some assets and liabilities at fair value, such as some debt and equity securities and derivatives.
- b. The disclosure of fair values of financial instruments.
- c. The expanded guidance on fair value measurements required by existing generally accepted accounting principles.
- d. The option of electing to measure certain financial instruments at their fair value.

However, while the authoritative guidance on fair value measurements is increasing, best practices indicate that the available guidance does not comprise a definite set of criteria and comprehensive fair value measurements should not be viewed as a special purpose framework.

The conclusion is not affected by Q&A 9110.21, *Reporting on Current-Value Financial Statements That Supplement Historical-Cost Financial Statements in Presentations of Real Estate Entities*. The Q&A states that AU-C 800.22 can be used as analogous guidance to conclude that positive assurance can be expressed on such current-value financial statements as long as the criteria for determining current values meet two conditions. However, AU-C 800.22 addresses reporting on financial statements, not supplemental presentations, and only when the auditor's report is prescribed by law or regulation. In addition, AU-C 800.22 uses the AU-C 800.07 definition of *special purpose framework*, whereas the Q&A uses two nonauthoritative conditions, and it is not clear whether the Q&A views current value as something other than fair value and why the scope is limited to presentations of real estate entities.

Liquidation Basis of Accounting

FASB ASC 205-30-25 provides guidance for when use of the liquidation basis of accounting is considered to be GAAP. The guidance indicates that an entity is required to prepare its financial statements using the liquidation basis of accounting when liquidation is imminent, which would be when either:

- a. a plan for liquidation has been approved by the person or persons with the authority to make such a plan effective and the likelihood is remote that the execution of the plan will be blocked by other parties or that the entity will return from liquidation, or
- b. a plan for liquidation is being imposed by other forces (for example, involuntary bankruptcy) and the likelihood is remote that the entity will subsequently return from liquidation.

FASB ASC 205-30-30 requires presenting assets and liabilities in the financial statements at the amount of cash or other consideration that the entity expects to collect or pay during the course of liquidation. FASB ASC 205-30-50-2 also requires disclosures about the entity's plan for liquidation, the methods and significant assumptions used to measure assets and liabilities, the type and amount of costs and income accrued, and the expected duration of liquidation.

Financial statements prepared on a liquidation basis could not be evaluated without the information discussed earlier. If liquidation is imminent, that information will be available. Instead of being a special purpose framework, the liquidation basis *is* GAAP for entities for which liquidation is imminent.

However, if liquidation is not imminent, hypothetical assumptions will need to be developed. Nevertheless, some accountants believe the liquidation basis may be used as a special purpose framework if liquidation is not imminent. Best practices indicate that the need to develop hypothetical assumptions effectively makes the financial statements *pro forma* financial information, presenting financial results using GAAP as if liquidation were imminent.

As a practical matter, small and midsize nonpublic entities for which liquidation is not imminent are not likely to find liquidation basis financial statements useful. If they are interested in the effects of liquidation, they would most likely want it presented as selected supplemental financial information.

The differences between the liquidation basis of accounting and the fair value basis of accounting can be subtle. The liquidation basis of accounting presents assets at amounts *expected to be realized in liquidation* and liabilities at amounts *expected to be paid to creditors*. Under the fair value basis of accounting, assets are presented at the *amounts at which they could be exchanged between well-informed and willing buyers and sellers* (that is, neither *compelled* to buy or sell) *at the date of the financial statements*, and liabilities are presented at the *discounted amount of cash to be paid*. Liquidation values sometimes are used as estimates of current value.

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 place emphasis on demonstrating the solvency of insurance companies to state regulators?
 - a. Regulatory Accounting Practices (RAP).
 - b. FASB ASC 980.
 - c. Statutory Accounting Practices (SAP).
2. Which of the following statements concerning audit performance considerations under the contractual basis of accounting is correct?
 - a. In accepting an engagement, auditors are required by AU-C 800.10 to determine if the use of a specialist is necessary.
 - b. When a special purpose framework is the contractual basis, auditors are required to obtain management's agreement that it acknowledges and understands its responsibility to include all informative disclosures that are appropriate.
 - c. Auditors are required to obtain an understanding of any significant contract interpretations that management made when preparing the financial statements.
 - d. Auditors should not make modifications to the financial statements in the case of contractual basis 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.)**

1. Which of the following place emphasis on demonstrating the solvency of insurance companies to state regulators? **(Page 4)**
 - a. Regulatory Accounting Practices. [This answer is incorrect. Regulatory accounting practices (RAP) are used by small credit unions (those with less than \$10 million in assets), not insurance companies.]
 - b. FASB ASC 980. [This answer is incorrect. FASB ASC 980 provides guidance on and accounting for certain aspects of regulated entities.]
 - c. **Statutory Accounting Practices (SAP).** [This answer is correct. The primary emphasis of SAP is on demonstrating the solvency (i.e., the ability to pay claims in the future) of insurance companies to state regulators.]
2. Which of the following statements concerning audit performance considerations under the contractual basis of accounting is correct? **(Page 6)**
 - a. In accepting an engagement, auditors are required by AU-C 800.10 to determine if the use of a specialist is necessary. [This answer is incorrect. In accepting the engagement, the auditor is required by AU-C 800.10 to determine the acceptability of the basis of accounting and obtain an understanding of (a) the purpose for which the financial statements are prepared, (b) the intended users, and (c) the steps taken by management to determine that the applicable financial reporting framework is acceptable in the circumstances.]
 - b. When a special purpose framework is the contractual basis, auditors are required to obtain management's agreement that it acknowledges and understands its responsibility to include all informative disclosures that are appropriate. [This answer is incorrect. When the special purpose framework is the contractual basis, management should include with those disclosures a description of any significant interpretations of the contract on which the financial statements are based.]
 - c. **Auditors are required to obtain an understanding of any significant contract interpretations that management made when preparing the financial statements.** [This answer is correct. AU-C 800.13 requires the auditor to obtain an understanding of any significant interpretations of the contract that management made in the preparation of the financial statements. An interpretation is considered to be significant when adopting some other reasonable interpretation would have caused a material difference in the information presented in the financial statements.]
 - d. Auditors should not make modifications to the financial statements in the case of contractual basis financial statements. [This answer is incorrect. The nature of the contractual basis may necessitate that the auditor modify certain procedures. For example, if the contractual basis requires that certain assets be stated at current replacement cost, the auditor may need to modify the audit procedures used to test asset valuation.]

Lesson 2: Reporting on Special Purpose Framework Financial Statements

INTRODUCTION

Practitioners have the same reporting alternatives for special purpose financial statements (such as cash, income tax, or regulatory basis financial statements) as they do for GAAP basis financial statements. That is, depending on the level of service provided, they issue compilation, review, or audit reports on the financial statements. The following sections discuss issues that should be considered when preparing compilation, review, or audit reports on special purpose financial statements. For further reporting guidance on compilations or reviews, refer to *PPC's Guide to Compilation and Review Engagements*. For additional reporting guidance on audit engagements, refer to *PPC's Guide to Auditor's Reports*.

The SSARS, *Statements on Standards for Accounting and Review Services*, include a provision for a non-reporting option in AR-C 70. The SSARS provide for different levels of service depending on whether the accountant is engaged to prepare financial statements or engaged to perform a compilation or review of the financial statements. (Although the accountant issues a report in a compilation engagement while a financial statement preparation engagement does not, neither of those engagements provides any assurance.) Detailed information on performing engagements under AR-C 70 can be found in *PPC's Guide to SSARS Preparation Engagements*.

SSARS No. 23, *Omnibus Statement on Standards for Accounting and Review Services—2016*, amends the accountant's compilation and review reports related to supplementary information and compilation engagements with known departures from the applicable financial reporting framework. The SSARS's amendments related to reporting on supplementary information were effective upon issuance on October 25, 2016, for compilations and reviews and have been incorporated throughout this course.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the required elements of compilation and review reports, how accountants deal with compilation reports when they lack independence, when financial statements omit substantially all disclosures, and when there are material measurement departures.
- Determine how accountants should use the various emphasis paragraphs in compilation and review reports.
- Determine how modifications are made to the auditor's standard reports.
- Identify how auditors report on regulatory basis financial statements as special purpose framework financial statements.
- Recognize how auditors prepare personal financial statements using the various bases of accounting.

General Reporting Considerations

Report Date. The date of completion of the compilation should be used as the date of the accountant's report on compiled financial statements (AR-C 80.17i). Best practices indicate that completion of a compilation generally occurs on the date the financial statements are *read*, as the term is used in AR-C 80.13. As a practical matter, the date probably has little bearing on the accountants' legal liability in a compilation engagement.

The date of completion of the accountant's review procedures should be used as the date of the accountant's report on reviewed financial statements (AR-C 90.39i). Review procedures include applying analytical procedures, making inquiries of management and other company personnel, reconciling the financial statements to the underlying accounting records, and obtaining management representations. The review report and management representation letter should be dated on the same day as required by AR-C 90.34. However, the accountant is not required to be in physical receipt of the management representation letter as of the date of the accountant's review report provided that management has acknowledged that they will sign the representation letter without modification and the letter is received prior to releasing the report.

The date of the auditor's report should not be earlier than the date when the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements (AU-C 700.41). The auditor cannot

simply use the date that the audit team left the field unless the auditor has sufficient appropriate audit evidence at that date. In addition, AU-C 580.20 requires management representations to be made as of the date of the auditor's report.

COMPILATION AND REVIEW REPORTS

Non-reporting Option

As previously mentioned, a non-reporting option is allowed under AR-C 70, *Preparation of Financial Statements*.

Required Elements of Compilation Reports

AR-C 80.17 requires a written report on compiled financial statements to—

- a. Include a statement that the management is responsible for the financial statements.
- b. Identify the financial statements that have been compiled.
- c. Identify the entity whose financial statements have been compiled.
- d. Specify the date or period covered by each financial statement.
- e. Include a statement that the accountant performed the compilation engagement in accordance with SSARS issued by the Accounting and Review Services Committee of the AICPA.
- f. Include a statement that the accountant has not audited or reviewed the financial statements, nor was required to perform any procedures to verify the accuracy or completeness of the information provided by management and, accordingly, does not express an opinion, a conclusion, or any assurance on the financial statements.
- g. Include the signature of the accounting firm or the accountant.
- h. Include the city and state where the accountant practices.
- i. Include the date of the compilation report. The date of the accountant's report should be the date of the completion of the compilation procedures.

When reporting on compiled financial statements prepared using a special purpose framework, AR-C 80.18–.21 has additional requirements for compilation reports, as explained below—

- The accountant should modify the compilation report when the financial statements do not include disclosure of the basis of presentation and disclosures similar to those required by GAAP when the financial statements include items that are the same as or similar to those in GAAP statements. If the compiled financial statements omit substantially all disclosures, then this requirement does not apply.
- The accountant should modify the compilation 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.
- The accountant's compilation 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 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; and (c) stating that the special purpose framework is a basis of accounting other than GAAP.

The report does not refer to any other procedures that the accountant may have performed. To do so might lead the reader of the financial statements to conclude that the accountant is, in fact, offering some form of assurance.

Required Elements of Review Reports

AR-C 90.39 requires a report on reviewed financial statements to—

- a. Have 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."
- b. Be addressed as appropriate in the circumstance.
- c. Have an introductory paragraph that:
 - Includes the identity of the entity whose financial statements have been reviewed;
 - States the financial statements have been reviewed;
 - Identifies the financial statements that have been reviewed;
 - Specifies the date or period covered by each financial statement;
 - Includes a statement that a review includes primarily applying analytical procedures to management's financial data and making inquiries of company management; and
 - Includes a statement that a review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole and that, accordingly, the accountant does not express such an opinion.
- d. Includes a section with the heading "Management's Responsibility for the Financial Statements" that includes a statement that management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and for designing, implementing, and maintaining internal control sufficient to provide a reasonable basis for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
- e. Includes a section with the heading "Accountant's Responsibility" that includes:
 - A statement that the accountant's responsibility is to conduct the review in accordance with SSARS issued by the Accounting and Review Services Committee of the AICPA;
 - A statement that those standards require the accountant to perform the review procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements for the financial statements to be in accordance with the applicable financial reporting framework; and
 - A statement that the accountant believes the review evidence is sufficient to provide a reasonable basis for the accountant's conclusion.
- f. Includes a concluding section with a heading that includes a statement about whether the accountant is aware of any material modifications that should be made to the financial statements for the financial statements to be in accordance with the applicable financial reporting framework and includes the country of origin of those accounting principles, if applicable.
- g. Include the signature of the accounting firm or the accountant.

- h. Include the city and state where accountant practices.
- i. Include the date of the review report. The date of the accountant's report should be the date of completion of the review procedures sufficient to obtain limited assurance, including evidence that:
 - Financial statements and related notes have been prepared and
 - Management has accepted responsibility for the financial statements and related notes.

When reporting on reviewed financial statements prepared using a special purpose framework, AR-C 90.40–.44 has additional requirements for review reports, as explained below—

- The accountant should modify the review report when the financial statements do not include disclosure of the basis of presentation and disclosures similar to those required by GAAP when the financial statements include items that are the same as or similar to GAAP statements.
- The accountant should modify the 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.
- The accountant's 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 review report should include a separate emphasis-of-matter paragraph with an appropriate heading (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; and (c) stating that the special purpose framework is a basis of accounting other than GAAP.
- 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. Restricting the use of the review report is discussed later in this lesson.

Any other procedures that the accountant may have performed before or during the review engagement, including those performed in connection with a compilation of the financial statements, are not described in the report.

Modifications to Compilation and Review Reports

The standard compilation report should be modified when the accountant is not independent or when the financial statements omit substantially all disclosures. Additionally, standard compilation and review reports should be modified when the financial statements contain departures from the applicable financial reporting framework. The following paragraphs discuss common issues that may require modifications to reports on compiled or reviewed special purpose framework financial statements.

Lack of Independence. While accountants are precluded from issuing audit or review reports when they are not independent, independence is not required to issue compilation reports provided accountants comply with the compilation standards. When the accountant is not independent, the compilation report should specifically disclose that fact by including the following as the last paragraph:

I am (We are) not independent with respect to XYZ Company.

Some accountants add this paragraph as a conservative practice. Accountants who are extensively involved in providing various accounting and consulting services to a given client may conclude that they are not independent

without analyzing each independence impairment for each compiled reporting period (for example, on a monthly or quarterly basis). These accountants need to consider the impact this approach could have on future engagements. A bank, bonding agent, or other third party may subsequently ask for reviewed financial statements at the end of the year, for which the accountant would be required to be independent. Best practices indicate that once an accountant has said they are not independent for a period, they may not subsequently rationalize their way back to being independent for that same period.

AR-C 80.23 also allows the accountant the option to disclose in the compilation report the reason(s) that independence is impaired. (If the accountant chooses to disclose the reasons, all of the reasons must be disclosed.) To reduce the risk of litigation, best practices suggest that the accountant simply add the paragraph illustrated earlier in this section without stating why independence is impaired. Because of the complexity of the independence rules, the accountant may disclose one reason for the lack of independence and overlook other independence impairments. This increases the liability risk to a user of the compiled financial statements that subsequently determines that other independence violations existed but were not disclosed.

If the accountant chooses to disclose the reason(s) for the lack of independence in the compilation report, the accountant should ensure that all reasons are included in the description. The following are some examples of descriptions the accountant may use:

- a. I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (a member of the engagement team) had a direct financial interest in XYZ Company.
- b. I am (We are) not independent with respect to XYZ Company 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 XYZ Company.
- c. I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (we) performed certain accounting services that impaired my (our) independence.

In making a decision about independence, the accountant should follow the AICPA *Code of Professional Conduct*. One aspect of determining independence that is often overlooked is the effect of uncollected client fees. Additionally, the Professional Executive Ethics Committee (PEEC) recently issued ET 1.295.143, *Hosting Services*, which indicates that when an AICPA member provides hosting services to an attest client (such as, maintaining the attest client's data or records on behalf of the client), independence would be impaired and could not be reduced to an acceptable level by the application of safeguards.

Substantially All Disclosures Omitted. Compiled financial statements may omit substantially all disclosures provided the compilation report discloses the omission and the omission is not, to the accountants' knowledge, undertaken to mislead those who might reasonably be expected to use the financial statements. AR-C 80.27 indicates that a separate paragraph should be added to the compilation report that includes specified elements. The following paragraph meets those requirements for a cash or tax basis compilation report—

Management has elected to omit substantially all the disclosures ordinarily included in financial statements prepared in accordance with the cash (or income tax) basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the Company's assets, liabilities, equity, revenues, and expenses. Accordingly, the financial statements are not designed for those who are not informed about such matters.

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. (The report would, however, still include a paragraph concerning the basis of accounting.)

The modification for compiled financial statements discussed earlier is not appropriate for reviewed financial statements because the omission of material disclosures is a departure from the applicable financial reporting framework and should be treated as such in the review report. Because of those requirements, accountants ordinarily would not accept an engagement to review financial statements that omit substantially all disclosures. When an accountant who undertakes to compile financial statements subsequently finds that the client declines to include substantially all disclosures, the accountant should consider whether the omission is undertaken with the intention of misleading those who will use the statements (AR-C 80.26).

Only Selected Information Is Disclosed. If compiled financial statements disclose only selected information, the disclosures may be labeled “SELECTED INFORMATION—Substantially All Disclosures Required by the [Cash Basis OR Income Tax Basis] of Accounting Are Not Included,” and a paragraph describing the omission of substantially all disclosures should be added to the compilation report. (Reviewed financial statements that omit substantially all disclosures are not appropriate.) Additionally, an accountant who knows or suspects that a disclosure has been omitted with the intention of misleading financial statement users should request that the financial statements be revised to include the omitted disclosures.

In a compilation that omits substantially all disclosures, what constitutes *substantially*? AR-C 80.28 helps to address this question by noting that when the financial statements include one or more disclosures, substantially all disclosures required by generally accepted accounting principles have *not* been omitted and the accountant would need to treat each disclosure omitted as a departure from the applicable reporting framework. However, there is no definition of how many disclosures constitute *one or more*, but rather leaves the determination of the exact number up to the accountant's judgment based on the particular circumstances.

However, AR-C 80.28 narrows this judgment area by stating that the omission of one or more notes, when substantially all other disclosures are presented, should be treated in a compilation report like any other departure from the applicable reporting framework, with the nature of the departure and its effects, if known, disclosed. Consequently, when only one or two notes are missing, the compilation does not omit *substantially* all disclosures. For discussed in this section for reporting on financial statements that omit substantially all disclosures is not appropriate. AR-C 80 and AR-C 90 provide guidance for reporting on financial statements that include a departure from the applicable financial reporting framework in compiled and reviewed statements. A more detailed discussion on reporting on financial statements containing departures from the applicable reporting framework is discussed below.

Disclosure of Basis of Accounting. AR-C 80.18 and AR-C 90.40 indicate that the accountant should modify his or her report when special purpose financial statements do not include a description of the special purpose framework, a summary of significant accounting policies, and an adequate description of how the special purpose framework differs from GAAP. A note in the financial statements disclosing the basis of accounting might read as follows:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

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.

Departures from the Applicable Financial Reporting Framework. When an accountant becomes aware of material measurement departures from the applicable financial reporting framework during the course of a compilation or review engagement, he or she has three possible courses of action:

- a. Persuade the client to revise the statements to conform with the applicable financial reporting framework.
- b. Refer to the departure in the compilation or review report.
- c. Withdraw from the engagement.

Obviously, revision of the statements is the preferred course of action. If revision is not feasible, reporting the departure in the compilation or review report is appropriate unless the accountant concludes that management's intention is to mislead the reader. If modifying the report to disclose the departure is not adequate and the client refuses to revise the statements, the accountant should withdraw from the engagement and consider consulting legal counsel (AR-C 80.32 and AR-C 90.59).

If modifying the accountant's report is appropriate, the nature of the departure should be disclosed in a separate paragraph, and the effects (dollar amount) of the departure should be disclosed, if known (AR-C 80.30 and AR-C 90.57). If the effects are not known, the accountant is not required to determine them, but instead should state in the report that no determination of the effects of the departure has been made by management (AR-C 80.31 and AR-C 90.58).

According to AR-C 80.A38 and AR-C 90.A106, an accountant cannot modify a compilation or review report to indicate that the financial statements are not fairly presented in conformity with the applicable financial reporting framework. Thus, an adverse opinion is not appropriate in a compilation or review engagement. An adverse opinion can only be expressed in an audit engagement. However, according to Paragraph 2.70 of the AICPA Guide, and AR-C 90.A107, the accountant may wish to emphasize the limitations of financial statements having significant departures (whether disclosure or measurement) in a separate other-matter paragraph in the report. The paragraph is in addition to a separate paragraph that describes the departure. In deciding whether to include such a paragraph, the accountant considers—

- a. the possible dollar magnitude of the departures,
- b. the significance of the affected items to the entity,
- c. the pervasiveness and overall impact of the misstatement, and
- d. whether the effects of the departure have been disclosed.

The separate other-matter paragraph of the accountant's compilation report might read as follows:

Because the significance and pervasiveness of the matters previously discussed makes it difficult to assess their impact on the financial statements as a whole, users of these financial statements should recognize that they might reach different conclusions about the company's financial position and results of operations if they had access to revised financial statements prepared in accordance with the income tax basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

Limitations of the Financial Statements

Because the significance and pervasiveness of the matters described in the Known Departures From Income Tax Basis of Accounting paragraph(s) makes it difficult to assess their impact on the financial statements, users of the accompanying financial statements should recognize that they might reach different conclusions about the company's financial position, results of operations, and cash flows if they had access to revised financial statements prepared in accordance with the income tax basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

Best practices indicate that the use of such other-matter paragraphs is optional and should be used only in rare situations 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 or may not cause such a pervasive impact on the financial statements and, accordingly, would not automatically call for the use of the optional paragraph.

Statement of Cash Flows Is Omitted. Special purpose financial statements need not present a statement of cash flows. Therefore, failing to present a statement of cash flows is not a departure from the applicable financial reporting framework, and the compilation or review report should not be modified. If an entity chooses to present a statement of cash flows as part of its special purpose financial statement presentation, the accountant should report on it as a basic financial statement—not as supplementary information.

Reporting When Other Accountants Have Audited or Reviewed a Component. If other accountants are engaged to audit or review the financial statements of a division, branch, subsidiary, or other investees, the accountant is required to obtain and read the reports from the other accountants (AR-C 90.25) and may use such reports from the other accountants as a basis, in part, for his report on his review of the financial statements of the reporting entity. The accountant may decide to refer to the work of other accountants in his review report on the financial statements. If such a reference is made, the report should indicate the magnitude of the portion of the financial statements reviewed or audited by the other accountants or auditors (AR-C 90.78). The disclosure of the magnitude of the portion of the financial statements reviewed by other accountants may be achieved by stating the dollar amounts or percentages of total assets, revenues, other criteria, or a combination of these.

Reporting When There Is a Change of Accountants. When an accountant is reporting on comparative financial statements of a nonpublic entity that include statements of a prior period previously reported on by another accountant, he or she has several options regarding the report on the prior period financial statements:

- a. Attempt to have the predecessor accountant reissue the report.
- b. Make reference to the predecessor accountant's report in his or her own report.
- c. Perform a compilation, review, or audit of the prior period financial statements and issue his or her own report.

Restated Prior-period Financial Statements. If the current period accountant is not a continuing accountant (i.e., the prior period was reported on by a predecessor and the financial statements of the prior period have been restated), three options exist—

- a. The predecessor accountant can reissue his or her report. AR-C 80, AR-C 90, and the AICPA Guide are silent on what considerations the predecessor would make in determining whether the report is still appropriate. Best practices indicate that predecessor accountants choose to perform certain procedures.
- b. The successor accountant can report on the financial statements for both years. If the successor chooses this option and reports on the restated financial statements, he or she performs a compilation or review in accordance with AR-C 80 or AR-C 90, respectively, or performs an audit in accordance with the auditing standards that relate to restated financial statements. A successor's report on restated prior period financial statements would not refer to the predecessor's previously issued report.
- c. An additional option is having the successor accountant report on the restatement adjustment only. In these reporting situations, the successor accountant indicates in an other-matter paragraph of his or her compilation or review report that a predecessor accountant reported on the financial statements of the prior period before restatement.

SELF-STUDY QUIZ

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

3. Which of the following is a required element of a compilation report?
 - a. A statement that the accountant is responsible for the financial statements.
 - b. A statement that the compilation was performed in accordance with SSARS.
 - c. The date of the engagement letter.
 - d. The beginning and ending date of the auditor's compilation procedures.
4. AR-C 90.39 requires a report on reviewed financial statements to include all of the following **except**:
 - a. A title that specifically indicates that it is the accountant's review report and includes the word independent.
 - b. The accountant's firm's signature.
 - c. The date of the accountant's review report.
 - d. A separate emphasis-of-matter paragraph with a heading referring to a note included in the financial statements that describes the framework.
5. Which of the following examples is correct regarding departures from the applicable financial reporting framework?
 - a. Felipe modifies the review report and discloses the nature of the departure in a separate paragraph.
 - b. Karen does not know the exact dollar amount of the disclosure, so she is required to make an estimate of the amount.
 - c. William modifies his review report to indicate that the financial statements are not presented fairly in conformity with the applicable financial reporting framework.
 - d. Kate's modification of her review report was not adequate and her client refused to revise the statements, so she referred to the departure in the review report.

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.)**

3. Which of the following is a required element of a compilation report? **(Page 14)**
 - a. A statement that the accountant is responsible for the financial statements. [This answer is incorrect. AR-C 80.17 requires a written report on compiled financial statements to include a statement that management, not the accountant, is responsible for the financial statements.]
 - b. A statement that the compilation was performed in accordance with SSARS. [This answer is correct. One of the elements required by AR-C 80.17 for compilation reports is a statement that the accountant performed the compilation engagement in accordance with SSARS issued by the Accounting and Review Services Committee of the AICPA.]**
 - c. The date of the engagement letter. [This answer is incorrect. A required element of the compilation report is the date of the compilation report which is the date the accountant completed the compilation procedures. The date of the engagement letter is not included.]
 - d. The beginning and ending date of the auditor's compilation procedures. [This answer is incorrect. AR-C 80.17 does not require the date the auditor began the compilation procedures. However, the accountant is required to specify the date or period covered by each financial statement.]
4. AR-C 90.39 requires a report on reviewed financial statements to include all of the following **except: (Page 16)**
 - a. A title that specifically indicates that it is the accountant's review report and includes the word independent. [This answer is incorrect. AR-C 90.39 requires a report on reviewed financial statements to have a title that clearly indicates that it is the accountant's review report and includes the *word independent*.]
 - b. The accountant's firm's signature. [This answer is incorrect. AR-C 90.39 requires a report on reviewed financial statements to include the signature of the accounting firm or the accountant.]
 - c. The date of the accountant's review report. [This answer is incorrect. AR-C 90.39 requires the date of the review report. The report date should be the date of completion of the review procedures sufficient to obtain limited assurance.]
 - d. A separate emphasis-of-matter paragraph with a heading referring to a note included in the financial statements that describes the framework. [This answer is correct. When reporting on reviewed financial statements prepared using a special purpose framework, AR-C 90.40–44 has additional requirements for review reports, one of which includes a separate emphasis-of-matter paragraph with an appropriate heading (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; and (c) stating that the special purpose framework is a basis of accounting other than GAAP.]**

5. Which of the following examples is correct regarding departures from the applicable financial reporting framework? **(Page 19)**
- a. **Felipe modifies the review report and discloses the nature of the departure in a separate paragraph. [This answer is correct. If modifying the accountant's report is appropriate, the nature of the departure should be disclosed in a separate paragraph, and the effects (dollar amount) of the departure should be disclosed, if known.]**
 - b. Karen does not know the exact dollar amount of the disclosure, so she is required to make an estimate of the amount. [This answer is incorrect. If the effects (dollar amount) of the departure are not known, Karen is not required to determine them, but instead should state in the report that no determination of the effects of the departure has been made by management.]
 - c. William modifies his review report to indicate that the financial statements are not presented fairly in conformity with the applicable financial reporting framework. [This answer is incorrect. William cannot modify a compilation or review report to indicate that the financial statements are not presented fairly in conformity with the applicable financial reporting framework because an adverse opinion is only relevant in an audit engagement.]
 - d. Kate's modification of her review report was not adequate and her client refused to revise the statements, so she referred to the departure in the review report. [This answer is incorrect. If modifying the report to disclose the departure is not adequate and the client refuses to revise the statements, the Kate should withdraw from the engagement and consider consulting legal counsel.]

Use of Emphasis-of-Matter and Other-Matter Paragraphs in Compilation and Review Reports

Accountants frequently ask whether they can add a paragraph to a compilation or review report to emphasize a matter regarding the financial statements. Emphasis-of-matter paragraphs may be included in the accountant's review report as a requirement of AR-C 90 or included in the accountant's compilation or review report at the accountant's discretion. Such paragraphs generally call attention to matters presented or disclosed in the financial statements that, in the accountant's professional judgment, are important to the users' understanding of the financial statements. Examples include paragraphs addressing going-concern problems, litigation matters, or related-party transactions. Emphasis-of-matter paragraphs are addressed in AR-C 90 as they relate to review reports, but are not discussed in AR-C 80. Paragraph 2.80 of the AICPA Guide indicates that there is no prohibition to the inclusion of emphasis-of-matter or other-matter paragraphs in compilation reports, and indeed, AR-C 80 requires an *additional* paragraph in certain instances. AR-C 90.52 states—

If the accountant considers it necessary to draw users' attention to a matter appropriately presented or disclosed in the financial statements that, in the accountant's professional judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the accountant should include an emphasis-of-matter paragraph in the accountant's review report, provided that the accountant does not believe that the financial statements may be materially misstated.

If the accountant expects to include an emphasis-of-matter or other-matter paragraph in the accountant's review report, the accountant should communicate with management regarding this expectation and the proposed wording of this paragraph.

An other-matter paragraph may be included in the accountant's review report as a requirement of AR-C 90 or included in the accountant's compilation or review report at the accountant's discretion. The paragraph refers to a matter other than those presented or disclosed in the financial statements that, in the accountant's professional judgment, are important to the users' understanding of the review, the accountant's responsibilities, or the accountant's compilation or review report. An other-matter paragraph does not include information that the accountant is prohibited from providing by law, regulation, other professional standards, or information that is required to be provided by management. AR-C 80 does not discuss the use of other-matter paragraphs in compilation reports and Paragraph 2.80 of the AICPA Guide notes that their use is not prohibited.

The accountant is required to include an additional paragraph in the accountant's compilation report relating to the following matters:

- a. When the financial statements are prepared in accordance with a special purpose framework, the compilation report should include an additional paragraph (AR-C 80.21).
- b. When the accountant is not independent, the accountant's compilation report should disclose the lack of independence in the last paragraph of the report (AR-C 80.22).
- c. When substantially all disclosures are omitted, the compilation report should disclose the omission (AR-C 80.27).
- d. When the accountant becomes aware of a departure from the applicable financial reporting framework (including inadequate disclosure) that is material to the financial statements and if the financial statements are not revised and the accountant has concluded that the modification of the standard report is adequate, the accountant's compilation report should include an other-matter paragraph (AR-C 80.34–.36).
- e. When supplementary information is included with the financial statements and the accountant's compilation report, the report should include an other matter paragraph (AR-C 80.34–.36).

The accountant is required to include an emphasis-of-matter or other-matter paragraph in the accountant's report review relating to the following matters:

- a. When the financial statements are prepared in accordance with a special purpose framework, the review report should include an emphasis-of-matter paragraph (AR-C 90.43).

- b. When management revises financial statements for a subsequently discovered fact that became known to the accountant after the report release date and the accountant's review report on the revised financial statements differs from the accountant's review report on the original financial statements, the accountant's review report should include an emphasis-of-matter paragraph (AR-C 90.75c).
- c. When the financial statements are prepared in accordance with a special purpose framework, the review report should include an other-matter paragraph that restricts the use of the accountant's review report when the financial statements are prepared in accordance to the contractual, regulatory, or (when applicable) other basis of accounting (AR-C 90.61–.62 and 90.A84).
- d. When the accountant's review report on the financial statements of the prior period contains a changed reference to a departure from the applicable financial reporting framework, the accountant's report should include an other-matter paragraph (AR-C 90.49).
- e. When the prior period financial statements were audited and the auditor's report on the prior period financial statements is not reissued, the review report on the current period financial statements should include an other-matter paragraph (AR-C 90.50).
- f. When the accountant becomes aware of a departure from the applicable financial reporting framework (including inadequate disclosure) that is material to the financial statements and if the financial statements are not revised and the accountant has concluded that the modification of the standard report is adequate, the accountant's review report should include an other-matter paragraph (AR-C 90.56–.60).
- g. When supplementary information is included with the financial statements and the accountant's review report, the report should include an other-matter paragraph (AR-C 90.80–.82).

While accountants generally can make whatever disclosures they deem appropriate in their compilation or review report, however, best practices suggest that accountants avoid using emphasis-of-matter or other-matter paragraphs when not required. Such paragraphs require accountants to choose the information in the financial statements that needs to be emphasized. There is no authoritative criteria for deciding when to use such paragraphs because the presumption is that all disclosures required in special purpose financial statements are important. Thus, choosing one matter to discuss could place undue emphasis on that matter and detract from other important disclosures. However, accountants may decide that an emphasis-of-matter paragraph is necessary to highlight an unusual or important matter that is disclosed in the financial statements, such as significant related party transactions or an unusually important subsequent event.

In addition to the emphasis-of-matter paragraphs listed earlier, the following are examples of circumstances when the accountant may consider it necessary to include an emphasis-of-matter paragraph:

- a. An uncertainty of an entity's ability to continue as a going concern for a reasonable period of time.
- b. An uncertainty relating to the future outcome of unusually important litigation or regulatory action.
- c. A major catastrophe that will have a significant effect on the entity's financial position.
- d. Significant transactions with related parties.
- e. Unusually important subsequent events.

Note that if the accountant determines that matters are not adequately disclosed in the financial statements, the accountant would be required to follow the requirements related to departures from the applicable financial reporting framework.

By definition, an emphasis-of-matter paragraph should only highlight or emphasize a matter already presented or disclosed in the financial statements. Best practices indicate that the following guidelines are also to be followed:

- a. Emphasis-of-matter paragraphs should not contain information about procedures the accountant has or has not performed.

- b. Emphasis-of-matter paragraphs should not contain information about the accountant's conclusions or opinions.
- c. If the accountant includes an emphasis-of-matter paragraph highlighting a going-concern disclosure in the client's financial statements, the term *substantial doubt* should not be used in the paragraph (AR-C 90.A118).

When the accountant includes an emphasis-of-matter paragraph it should (AR-C 90.53):

- a. Be immediately after the accountant's conclusion paragraph in the accountant's review report or the final paragraph in a compilation report.
- b. Have a heading titled "Emphasis of a Matter" or other appropriate heading. In a compilation report, the use of headings is optional.
- c. Include a reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements.
- d. In a review report, indicate that the accountant's conclusion is not modified with respect to the matter emphasized. This requirement is not necessary in a compilation as the accountant has not reached or reported any conclusion.

Uncertainties about the Entity's Ability to Continue as a Going Concern.

Conditions indicating substantial doubt about the entity's ability to continue as a going concern may not be as evident in pure cash and modified cash basis financial statements as they are in financial statements prepared using generally accepted accounting principles. For example, a statement of cash receipts and disbursements prepared under the pure cash basis may reflect an increase in cash even though the entity has suffered recurring losses. The remainder of this discussion addresses the going concern consideration regardless of the basis of accounting used.

Accountants are not required to add an emphasis-of-matter paragraph for going concern matters to their compilation or review report. However, AR-C 90.68 discusses an uncertainty about an entity's ability to continue as a going concern. AR-C 90.A117 indicates that, although permitted, accountants are not required to add an emphasis-of-matter paragraph to the standard review report for going-concern matters provided that financial statement disclosure is adequate. Although not specifically addressed in AR-C 80, the AICPA Guide, Paragraph 2.100, Illustration 18, provides an example of a compilation report with an emphasis-of-matter paragraph addressing a going concern uncertainty.

The discussion of adding an emphasis-of-matter paragraph for a going concern uncertainty in a compilation or review report differs from the guidance later in this lesson that *requires* auditors to add an explanatory paragraph to their report when a going concern uncertainty exists. Additionally, note that AU-C 570 requires that the terms *substantial doubt* and *going concern* be used in the explanatory paragraph when the auditor concludes that substantial doubt exists. That doubt, however, is based on evidence obtained from procedures performed in an audit, not in a compilation or review. Therefore, accountants would not use the phrase *substantial doubt about the entity's ability to continue as a going concern* in an emphasis-of-matter paragraph of a compilation or review report.

After considering the circumstances and management's plans, if the accountant wishes to draw attention to the going concern uncertainty, an emphasis-of-matter paragraph such as the following would be appropriate in a review report:

Going Concern

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X, certain conditions raise an uncertainty about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The accompanying financial statements do not include any adjustments to the financial statements that might result from the outcome of this uncertainty. My (Our) conclusion is not modified with respect to this matter.

The last sentence in the above illustration would not be included in a compilation report as the accountant states no conclusion in a compilation report. If going concern matters are not disclosed adequately in full disclosure financial statements, accountants should modify their reports for the departure from the applicable financial reporting framework. AR-C 80.A21 addresses those situations where the accountant has compiled financial statements that omit substantially all disclosures. In those instances, the disclosure of an uncertainty is not required in financial statements that omit substantially all disclosures. The user of these financial statements is considered to be adequately warned of the limitations of such financial statements by the report language.

Uncertainties Regarding Tax Positions. There may be circumstances when the proper tax treatment of a transaction or item entering into the tax calculation is unclear based on existing tax laws and court cases.

Change in Accounting Principle. A change in accounting principle does not require modifying the accountant's compilation or review report or adding an emphasis-of-matter or other-matter paragraph. However, an accountant is not precluded from adding such a paragraph about the change as long as the change is disclosed in the financial statements. However, for the reasons discussed earlier in this section, best practices suggest that accountants avoid using emphasis-of-matter and other-matter paragraphs whenever possible.

If accountants choose to add a paragraph to their report highlighting the change in accounting principle, the following language might be used:

As described in Note X, in 20XX the Company changed its policy for determining cash equivalents.

If the change in accounting principle is not properly accounted for, management does not have reasonable justification for the change, or appropriate disclosures are not included in the financial statements, accountants would modify their compilation or review reports because of a departure from the applicable financial reporting framework.

A change in tax law is not considered to be a change in accounting principle in tax basis financial statements. On the other hand, a change in the way a company treats an item for tax purposes (assuming tax law did not change) is considered a change in accounting principle in tax basis financial statements.

Change in Basis of Accounting. Companies sometimes change the basis of accounting used to present their financial statements from a special purpose framework to GAAP, from GAAP to a special purpose framework, or from one special purpose framework to another. For example, a company that used the income tax basis to prepare its financial statements in prior years may decide to use GAAP to prepare its current-year statements. Audit literature states that such changes may be, but are not required to be, mentioned in an emphasis-of-matter paragraph to the audit report.

FASB ASC 250-10 provides guidance on measurement and disclosure of an accounting change, which FASB ASC 250-10-20 refers to as “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 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 income 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, a Q&A 9030.10 states when a change in accounting basis occurs, it should be disclosed in the notes to the financial statements. The authors' opinion 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 to highlight a change in the financial reporting framework. If accountants decide to add an emphasis-of-matter paragraph to their report, and the financial statements appropriately disclose the change in basis, an explanatory paragraph such as the following may be added to the compilation report:

As discussed in Note X to the financial statements, in 20XX the Company adopted a policy of preparing its financial statements on the basis of accounting it uses for federal income tax purposes, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The 20XW financial statements have been restated on the basis of accounting adopted in 20XX.

In a review report, an emphasis-of-matter paragraph such as the following may be added:

Change in Basis of Accounting

As discussed in Note X to the financial statements, in 20XX the Company adopted a policy of preparing its financial statements on the basis of accounting it uses for federal income tax purposes, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The 20XW financial statements have been restated on the basis of accounting adopted in 20XX. Our conclusion is not modified with respect to this matter.

However, if the statements do not appropriately disclose the change in basis, the compilation or review report should be modified for a departure from the applicable financial reporting framework.

Use of Different Bases of Accounting for Financial Statements of the Same Period. Companies may request that accountants compile or review financial statements for the same period based on different bases of accounting. 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, best practices indicate that accountants are permitted (but not required) to add such a paragraph to their compilation or review reports.

Restricting the Use of Reports

AR-C 90.61–.62 describe the circumstances in which accountants should restrict their reports in an other-matter paragraph, and specifies the language that should be used in accountant's reports that are restricted as to use.

Restricted use reports are intended only for one or more specified third parties. All other reports are considered to be *general use* reports. AR-C 90.61–.62 indicate that the use of a accountant's review report should be restricted when the subject matter of the report or presentation being reported on is based on measurement or disclosure criteria suitable only for a specific audience. AR-C 90.44 indicates that such a paragraph should be included in an accountant's review report on contractual or regulatory basis financial statements or other basis financial statements meeting the criteria at AR-C 90.61. AR-C 80 does not address restricted use reports. However, the AICPA Guide, Paragraph 2.78, notes that an accountant may use a restricted use paragraph in a compilation report.

Some CPAs have asked, however, if it is permissible to restrict the use of compilation and review reports that are not otherwise required by professional standards to be restricted. The answer is yes, such restriction is permissible. Although there are circumstances when the report is required to carry a use restriction, the accountant is not prohibited from restricting the use of any report. Best practices suggest that a practitioner who believes that restriction may be desirable consider the following issues:

- Will the proposed restriction mitigate the practitioner's risk of lawsuits?
- Will the client accept the proposed restriction?

If the accountant issues a combined report that covers subject matter required to be restricted, as well as subject matter not required to be restricted, the accountant should restrict the use of all of the subject matter. However, when required by law to issue a separate restricted-use report in a document that also contains a general-use report, the restricted-use report remains restricted as to use, and the general-use report continues for general use. The restricted-use subject matter, however, should be clearly labeled.

Accountants may be asked to add other specified parties after the completion of the compilation or review engagement. If the accountant agrees to such a request, although not required by the SSARS, it is recommended that the accountant obtain affirmative acknowledgment, preferably in writing, from the other parties of their understanding of the nature of the engagement, the measurement or disclosure criteria used in the engagement, and the related report. If the other parties are added after the accountant has issued his or her report, the report may be reissued with the additional specified parties listed or the accountant may provide a written acknowledgment to management and the additional parties acknowledging that the additional parties have been added as specified parties. If the report is reissued, the report date should not be changed. If the acknowledgment is made to management, it should state that no procedures have been performed subsequent to the date of the report (AR-C 90.63–.64).

According to AR-C 90.61–.62 the restricted-use accountant's report should (a) indicate that the report is intended solely for the information and use of the specified parties, (b) identify the specified parties, either in the report or by referring to the specified parties listed elsewhere in the report, and (c) state that the report is not intended to be and should not be used by anyone other than the specified parties. Accountants may choose to add the restricted use language to their engagement letters. A paragraph such as the following may be used as the last paragraph in the restricted use accountant's review report:

Restriction on Use

This report is intended solely for the information and use of [Specified Parties] and is not intended to be and should not be used by anyone other than these specified parties.

The same restricted-use language may be used in the accountant's compilation report, but without a paragraph heading.

Note that the report language restricts the use, not the distribution, of the report. Because of the reasons described earlier in this section, the accountant needs to inform his or her client that restricted-use reports are not intended for distribution to nonspecified parties. Accountants may choose to add the restricted use language to their engagement letters. The accountant, however, is not responsible for controlling a client's distribution of restricted-use reports.

Client-prepared Financial Statements

A longstanding concern among accountants is whether presenting client-prepared financial statements that have not been compiled, reviewed, or audited with financial statements that have been compiled, reviewed, or audited will confuse readers of the client-prepared statements as to the responsibility the accountant is taking for them.

According to Paragraph 2.52 of the AICPA Guide, whenever the accountant becomes aware that financial statements of other periods that have not been audited, reviewed, or compiled have been presented in columnar form in a document with financial statements on which he or she has reported and that his or her name has been used or with his or her report included in the document, the accountant may advise his or her client that the client-prepared financial statements should be accompanied by a clear indication that the accountant has not audited, reviewed, or compiled those financial statements and that the accountant assumes no responsibility for them. The following paragraphs discuss several reporting issues in relation to client-prepared financial statements.

Client-prepared Financial Statements Bound in the Accountant's Report Cover. When an accountant binds client-prepared financial statements of a prior period with his or her compilation or review report on the current period, best practices indicate that the practitioner may indicate in the compilation or review report that he or she has not audited, reviewed, compiled, or prepared the prior-period financial statements and that he or she does not assume any responsibility for them.

Client-prepared Financial Statements Attached by the Client. Once the accountant delivers his or her report on compiled or reviewed financial statements, in reality, he or she has little control over, or awareness of, the client's subsequent actions. However, situations will occur when the accountant becomes aware that the financial statements will be combined with client-prepared financial statements into a new document. (A file folder that contains loose copies of client-prepared financial statements and the separately bound compiled or reviewed financial statement in the accountant's report jacket to be a new document.) When the accountant becomes aware that such a "new document" will be created by the client, best practices indicate that:

- a. If the accountant's name is in no way mentioned in the new client-prepared document, the accountant has no other responsibility. In other words, the compiled or reviewed financial statements have been retyped by the client on plain paper, the accountant's report has been removed, and no reference is made about the accountant in the document.
- b. If the accountant's name is mentioned in the new client-prepared document, then a distinction would be made regarding whether client-prepared financial statements are presented on a separate page from, or typed alongside (parallel to), the compiled/reviewed financial statements.
 - (1) If the client-prepared financial statement is presented on a separate page, the accountant should request that the client add a disclaimer.
 - (2) If the client-prepared financial statement is presented alongside the compiled/reviewed/audited financial statement, the accountant should advise the client to (a) remove all mention of the accountant's name from the document, (b) move the client-prepared statement to a separate page and add a disclaimer, or (c) have the accountant also prepare, compile, review, or audit the client-prepared statement.

The Client's Disclaimer. As noted earlier, if a client-prepared document mentions the accountant's name in any manner, it is believed that any client-prepared financial statements in such document need to (a) be presented on a page separate from compiled, reviewed, or audited financial statements and (b) contain a disclaimer. In the authors' opinion, the client's disclaimer would be presented on a page immediately preceding the client-prepared financial statements or on the face of such statements. Although not mandatory, an officer of the company could sign the disclaimer. Such a disclaimer might read as follows:

The 20X1 financial statements have been prepared solely by the staff of XYZ Company and have not been audited, reviewed, compiled, or prepared by the accounting firm of Jones and Morrison. Furthermore, Jones and Morrison assume no responsibility for the 20X1 financial statements.

Larry Adams
Controller—XYZ Company

When the accountant is clearly aware that the client intends to attach client-prepared financial statements to the document submitted by the accountant, he or she may add the following disclaimer to his or her report before it is delivered to the client.

All other information that may be included with (or attached to) the financial statements (and supplementary information) identified in the preceding paragraphs has not been audited, reviewed, compiled, or prepared by me (us) and, accordingly, I (we) assume no responsibility for it.

Reporting on Compiled or Reviewed Supplementary Information

SSARS require that accountants indicate the degree of responsibility, if any, they are taking with respect to the supplementary information presented with the basic financial statements that the accountant has compiled. If the supplementary information has been compiled by the accountants, an other-matter paragraph would be added to the standard compilation report that reads as follows. (Because headings are not needed in compilation reports, the accountant need only add the supplementary information paragraph.)

The supplementary information contained in Schedules X and XX is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information is the responsibility of management. The supplementary information was subject to my (our) compilation engagement. I (We) have not audited or reviewed the supplementary information and do not express an opinion, a conclusion, nor provide any assurance on such information.

The accountant may prefer to present a standard compilation report on the basic financial statements and issue a separate report on the compilation of the supplementary information.

If the supplementary information has *not* been compiled by accountant, an other-matter paragraph would be added to the standard compilation report that reads as follows:

The supplementary information contained in Schedules X and XX is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information is the responsibility of management. The supplementary information was not subject to my (our) compilation engagement. I (We) do not express an opinion, conclusion, nor provide any assurance on such information.

This paragraph can also be issued as a separate report. Best practices indicate that this report is applicable when the client has prepared the supplementary information and it is bound with the accountant's report. If a separate report is issued, the accountant may consider adding a first sentence that refers to the accountant's compilation report on the basic financial statements.

The illustrations of supplementary information included in the accountant's report listed earlier do not include a reference to the basis of accounting used. When supplementary information is presented that has been prepared using a special purpose framework, the accountant may choose to include the basis of accounting used in the title of the supplementary information, such as "Schedule of General and Administrative Expenses—Income Tax Basis."

When reviewed financial statements are accompanied by supplementary information (whether prepared by the accountant or by the client), AR-C 90.80–.82 requires the accountant to clearly indicate the degree of responsibility, if any, he or she is taking regarding the supplementary information in either an other-matter paragraph in his or her review report on the basic financial statements or a separate report on the supplementary information. When the accountant has reviewed such information, the other-matter paragraph or the separate report should include:

- a. A heading titled *Other Matter* or another appropriate heading such as *Supplementary Information*.
- b. The supplementary information is presented only for additional analysis purposes and is not a required part of the financial statements.
- c. The supplementary information is the responsibility of management, and such information was derived from, and relates directly to, the underlying records (accounting or other) used to prepare the financial statements.
- d. The supplementary information was subjected to the review procedures applied in the accountant's review of the basic financial statements and based on the accountant's review, whether the accountant is aware of any material modifications that should be made to the information.
- e. The accountant has not audited the supplementary information and, accordingly, does not express an opinion on such information.

If the accountant did not review the supplementary information, his or her report should include items a. and b., but item c. should not be included, and item d. should be modified as follows:

The other matter paragraph should follow the conclusion paragraph and any emphasis-of-matter paragraphs, if applicable.

When the accountant has not reviewed the supplementary information, the other-matter paragraph or the separate report should include:

- a. A heading titled *Other Matter* or another appropriate heading such as *Supplementary Information*.

- b. The supplementary information is presented only for additional analysis purposes and is not a required part of the financial statements.
- c. The supplementary information is the responsibility of management.
- d. The accountant has not audited or reviewed the supplementary information and, accordingly, does not express an opinion, conclusion, nor provide any assurance on such information.

The other matter paragraph should follow the conclusion paragraph and any emphasis-of-matter paragraphs, if applicable.

SELF-STUDY QUIZ

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

6. Which of the following statements regarding the use of emphasis-of-matter or other-matter paragraphs in compilation and review reports is correct?
 - a. Accountants should avoid using emphasis-of-matter paragraphs.
 - b. The SSARS provides detailed guidance on when accountants should use emphasis-of-matter paragraphs.
 - c. If an emphasis-of-matter paragraph is used, it should present new information that is not included in the financial statements.
7. Which of the following statements concerning a change in accounting principle is correct?
 - a. A change in tax law is considered to be a change in accounting principle in tax basis financial statements.
 - b. Accountants are not required to add an emphasis-of-matter paragraph to their compilation or review report if an accounting principle changes.
 - c. Management can justify a change in accounting principle even if the change is not properly accounted for.
8. Which of the following statement regarding a change in basis of accounting is correct?
 - a. When a company changes their basis of accounting, they are required to be mentioned in an emphasis-of-matter paragraph to the audit report.
 - b. FASB ASC 250-10-20 refers to a change in accounting principle as a change in reporting entity or an accounting estimate.
 - c. The guidance in FASB ASC 250-10 was designed to address a change from one financial reporting framework to another financial reporting framework.
 - d. A change in accounting basis should not be disclosed in the notes to the financial statements.
9. Chaz is hired to review a company's income tax basis financial statements. He also reviews supplementary information that must be presented along with the basic financial statements. Chaz presents the supplementary information in his review report. Which of the following must be indicated in Chaz's report?
 - a. The supplementary information is presented only for additional inquiry purposes and is not a required part of the financial statements.
 - b. The degree of responsibility he is taking with respect to the supplementary information presented with the basic financial statements he has compiled.
 - c. That the supplementary information is the responsibility of management.
 - d. A title used in the supplementary information such as "Schedule of General and Administrative Expenses—Income Tax 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.)**

6. Which of the following statements regarding the use of emphasis-of-matter or other-matter paragraphs in compilation and review reports is correct? **(Page 25)**
- a. **Accountants should avoid using emphasis paragraphs. [This answer is correct. While accountants generally can make whatever disclosures they deem appropriate in their compilation or review report, best practices suggest that accountants avoid using emphasis-of-matter or other-matter paragraphs when not required.]**
 - b. The SSARS provides detailed guidance on when accountants should use emphasis-of-matter paragraphs. [This answer is incorrect. There are no authoritative criteria for deciding when to use an emphasis-of-matter paragraph because the presumption is that all disclosures required in special purpose financial statements are important. Thus, choosing one matter to discuss in an emphasis-of-matter paragraph could place undue emphasis on that matter and detract from other important disclosures.]
 - c. If an emphasis-of-matter paragraph is used, it should present new information that is not included in the financial statements. [This answer is incorrect. In accordance with the SSARS, the emphasis-of-matter paragraph should not introduce new information to the reader of the financial statements. Accordingly, emphasis-of-matter paragraphs should only highlight or emphasize a matter already disclosed in the financial statements.]
7. Which of the following statements concerning a change in accounting principle is correct? **(Page 27)**
- a. A change in tax law is considered to be a change in accounting principle in tax basis financial statements. [This answer is incorrect. According to the SSARS, a change in tax law is not considered to be a change in accounting principle in tax basis financial statements. On the other hand, a change in the way a company treats an item for tax purposes (assuming tax law did not change) is considered a change in accounting principle in tax basis financial statements.]
 - b. **Accountants are not required to add an emphasis-of-matter paragraph to their compilation or review report if an accounting principle changes. [This answer is correct. A change in accounting principle does not require modifying the accountant's compilation or review report or adding an emphasis paragraph. However, an accountant is not precluded from adding an emphasis paragraph about the change as long as the change is disclosed in the financial statements.]**
 - c. Management can justify a change in accounting principle even if the change is not properly accounted for. [This answer is incorrect. If the change in accounting principle is not properly accounted for, management does not have reasonable justification for the change, or appropriate disclosures are not included in the financial statements, accountants would modify their compilation or review reports because of a departure from the applicable financial reporting framework.]
8. Which of the following statements regarding a change in basis of accounting is correct? **(Page 27)**
- a. When a company changes their basis of accounting, they are required to mention it in an emphasis-of-matter paragraph to the audit report. [This answer is incorrect. Companies sometimes change the basis of accounting used to present their financial statements from a special purpose framework to GAAP, from GAAP to a special purpose framework, or from one special purpose framework to another. Audit literature states that such changes may be, but are not required to be, mentioned in an emphasis-of-matter paragraph to the audit report.]
 - b. **FASB ASC 250-10-20 refers to a change in accounting principle as a change in reporting entity or an accounting estimate. [This answer is correct. FASB ASC 250-10 provides guidance on measurement and disclosure of an accounting change, which FASB ASC 250-10-20 refers to as a change in an accounting principle, a change in an accounting estimate, or a change in the reporting entity.]**

- c. The guidance in FASB ASC 250-10 was designed to address a change from one financial reporting framework to another financial reporting framework. [This answer is incorrect. The guidance in FASB ASC 250-10 was 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.]
 - d. A change in accounting basis should not be disclosed in the notes to the financial statements. [This answer is incorrect. A Q&A 9030.10 states that when a change in accounting basis occurs, it should be disclosed in the notes to the financial statements.]
9. Chaz is hired to review a company's income tax basis financial statements. He also reviews supplementary information that must be presented along with the basic financial statements. Chaz presents the supplementary information in his review report. Which of the following must be indicated in Chaz's report? **(Page 28)**
- a. The supplementary information is presented only for additional analysis and is not a required part of the financial statements. [This answer is incorrect. If Chaz applied inquiry and analytical procedures to the supplementary information, either an other-matter paragraph in the accountant's review report on the basic financial statements or a separate report accompanying the supplementary information should indicate that the supplementary information is presented only for the purpose of additional analysis and is not a required part of the financial statements.]
 - b. The degree of responsibility he is taking with respect to the supplementary information presented with the basic financial statements he has compiled. [This answer is correct. SSARS require that accountants indicate the degree of responsibility, if any, they are taking with respect to the supplementary information presented with the basic financial statements that the accountant has compiled.]**
 - c. That the supplementary information is the responsibility of management. [This answer is incorrect. If the accountants applied inquiry and analytical procedures to the supplementary information, either an other-matter paragraph in the accountant's review report on the basic financial statements or a separate report on the supplementary information should indicate that the supplementary information is the responsibility of management.]
 - d. A title used in the supplementary information such as "Schedule of General and Administrative Expenses—Income Tax Basis." [This answer is incorrect. When supplementary information is presented that has been prepared using a special purpose framework, the accountant may choose to include the basis of accounting used in the title of the supplementary information, such as "Schedule of General and Administrative Expenses—Income Tax Basis." However, this is not required to be in the report.]

AUDITOR'S REPORTS

The Standard Report

The reporting standards for auditor's reports on special purpose financial statements are prescribed by AU-C 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*. AU-C 800 also provides illustrations of reports. The reporting standards are similar to those for reporting on GAAP basis financial statements prescribed by AU-C 700, *Forming an Opinion and Reporting on Financial Statements*. Similar to an auditor's report on GAAP financial statements, the report on special purpose financial statements should include the following (AU-C 700.25–.36):

- a. An introductory paragraph that (1) identifies the entity whose financial statements have been audited, (2) states the financial statements have been audited, (3) identifies the title of each financial statement, and (4) specifies the date or period covered by each financial statement.
- b. A section with a heading "Management's Responsibility for the Financial Statements" that describes management's responsibility for the preparation and fair presentation of the financial statements, including an explanation that management is responsible for the preparation and fair presentation of the financial statements in accordance with the special purpose framework, which includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error. (A separate statement by management about such responsibilities should not be included if such a statement is included in a document containing the auditor's report.)
- c. A section with the heading "Auditor's Responsibility" that (1) states that the auditor's responsibility is to express an opinion on the financial statements based on the audit, (2) states that the audit was conducted in accordance with auditing standards generally accepted in the United States of America and that those standards require the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, and (3) describes the audit by stating that:
 - An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements.
 - The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatements. In assessing those risks, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control, and, accordingly, no such opinion is expressed.
 - An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of significant accounting estimates made by management, as well as the overall presentation of the financial statements.
- d. A statement about whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.
- e. A section with the heading "Opinion" that states the auditor's opinion that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows in accordance with the special purpose framework and identifies the applicable reporting framework.

In addition to those elements, AU-C 800 states that an auditor's report on special purpose financial statements should include the following:

- a. In the section titled "Management's Responsibility for the Financial Statements," a 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 in the preparation of such financial statements. (AU-C 800.18a)

- b. An emphasis-of-matter paragraph, under an appropriate heading, that indicates that the financial statements are prepared in accordance with the applicable special purpose framework, refers to the note to the financial statements that describes that framework, and states that the special purpose framework is a basis of accounting other than GAAP (AU-C 800.19). When the financial statements are prepared in accordance with a regulatory or contractual basis of accounting, or an other basis of accounting and the auditor is required to restrict use of the report pursuant to AU-C 905.06, a–b, the paragraph also should include a description of the purpose for which the financial statements are prepared or a reference to a note that contains that information. (AU-C 800.18b)

The difference between GAAP and the special purpose framework need not be described in the auditor's report. Rather, a description of the basis and the primary differences from GAAP should be included in the notes to the financial statements.

- c. An other-matter paragraph, under an appropriate heading, that restricts the use of the auditor's report when the special purpose financial statements are prepared in accordance with a contractual basis of accounting, a regulatory basis of accounting, or an other basis of accounting when required under AU-C 905.06, a–b (AU-C 800.20).

Modifications to the Auditor's Report

AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*, indicates that the auditor's report should be modified in the following situations:

- a. *Qualified Opinion*. The auditor should express a qualified opinion when—(AU-C 705.08)
 - the auditor concludes that misstatements, individually or in the aggregate, are material but not pervasive to the financial statements, or
 - the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Material and pervasive circumstances may require an adverse opinion when a departure from the applicable financial reporting framework exists or a disclaimer of opinion when a scope limitation exists.

- b. *Adverse Opinion*. Auditors give an adverse opinion when they conclude that misstatements, individually or in the aggregate, from the special purpose framework are both material and pervasive to the financial statements (AU-C 705.09). Adverse opinions are rare in practice because their implications are so serious that they usually cause the company to correct the financial statements.
- c. *Disclaimer of Opinion*. A disclaimer of opinion states that the auditors are unable to obtain sufficient appropriate audit evidence on which to base the opinion on the financial statements and the auditors conclude that the possible effects of undetected misstatements, if any, could be both material and pervasive. Generally, auditors issue a disclaimer of opinion when they are faced with a scope limitation so significant that they believe a qualified opinion is not appropriate.

Emphasis-of-matter and Other-matter Paragraphs in the Auditor's Report

AU-C 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*, addresses situations when additional communications might be appropriate in the auditor's report:

- *Required Elements of an Emphasis-of-matter Paragraph*. AU-C 706.07 requires an emphasis-of-matter paragraph to (a) use the heading "Emphasis of Matter" or other appropriate heading, (b) include a reference to the matter being emphasized and to where in the financial statements disclosures relevant to the matter can be found, and (c) state that the emphasis paragraph does not modify the auditor's opinion on the financial statements. When practicable, the authors prefer to use a heading for the emphasis paragraph that is descriptive of the matter being emphasized. For example, an emphasis-of-matter

paragraph describing a change in accounting principle might use a heading such as “Change in Accounting Principle,” and an emphasis paragraph describing the auditor’s doubt about the entity’s ability to continue as a going concern might use a heading such as “Uncertainty Regarding Going Concern or Emphasis-of-matter Regarding Going Concern.” The emphasis-of-matter paragraph should immediately follow the opinion paragraph.

- *Required Elements of an Other-matter Paragraph.* AU-C 706.08 requires an other-matter paragraph to use the heading “Other Matter” or other appropriate heading. When practicable, the authors prefer to use a heading that is descriptive of the matter being emphasized. For example, an other-matter paragraph that presents the auditor’s report on supplementary information accompanying the financial statements might use a heading such as “Report on Supplementary Information,” and an other-matter paragraph restricting the use of the auditor’s report when the financial statements are prepared on the regulatory basis of accounting might use a heading such as “Restriction on Use.” In most cases, the other-matter paragraph should immediately follow the opinion paragraph and any emphasis-of-matter paragraphs. Because an other-matter paragraph refers to matters other than those that are appropriately presented or disclosed in the financial statements, it would be inappropriate for the content of an other-matter paragraph to imply that the matter is required to be presented and disclosed in the financial statements. An other-matter paragraph also does not include (a) information that the auditor is prohibited from providing by law, regulation, or other professional standards (for example, ethical standards relating to the confidentiality of information) or (b) information that is required to be provided by management.

Exhibit 2-1 lists various circumstances and describes how the standard audit report should be modified in each situation. The following paragraphs discuss common modifications to auditor’s reports on special purpose framework financial statements in further detail. See *PPC’s Guide to Auditor’s Reports* for further information on modifications to auditor’s reports.

Exhibit 2-1

Modifying the Auditor’s Standard Report

Type of Report	Circumstance	Materiality ^a	How to Modify the Standard Report
QUALIFIED OPINION	Departure from special purpose framework (measurement or disclosure)	Material	Modify the section describing the auditor’s responsibility, add a separate basis for qualified opinion paragraph preceding the opinion paragraph, and qualify the opinion (except for).
	Scope limitation	Material	Modify the section describing the auditor’s responsibility, add a separate basis for qualified opinion paragraph preceding the opinion paragraph, and qualify the opinion (except for).
ADVERSE OPINION	Pervasive departure from special purpose framework	Material	Modify the section describing the auditor’s responsibility, add a separate basis for adverse opinion paragraph preceding the opinion paragraph, and modify the opinion to state “do not present fairly in accordance with (the special purpose framework).”

Type of Report	Circumstance	Materiality ^a	How to Modify the Standard Report
DISCLAIMER OF OPINION	Pervasive scope limitation	Material	Modify the introductory paragraph, and the section describing the auditor's responsibility, add a basis for disclaimer of opinion paragraph, and modify the opinion paragraph to state "we do not express an opinion."
	Not independent and a nonpublic company ^b	n/a	Issue a SSARS compilation report that states the lack of independence. ^c
	Unaudited financial statements of a nonpublic company ^b	n/a	Issue a SSARS compilation or review report.
UNMODIFIED OPINION WITH EMPHASIS-OF-MATTER OR OTHER-MATTER PARAGRAPH	Auditor's decide or are required to emphasize a matter appropriately presented or disclosed in the financial statements	n/a	Add a separate emphasis-of-matter paragraph following the opinion paragraph discussing the matter, but issue an unmodified opinion.
	Auditor's decide or are required to emphasize a matter other than those presented or disclosed in the financial statements	n/a	Add a separate other-matter paragraph following the opinion paragraph (and any emphasis-of-matter paragraphs) discussing the matter, but issue an unmodified opinion.

Notes:

- ^a If the circumstance is not material to the financial statements as a whole, auditors should not modify the standard report.
- ^b These types of reports are referred to as disclaimers of opinion even though the term *disclaimer* in AU-C 705 is used in a narrower sense.
- ^c AR-C 80 allows an accountant to include a description in the compilation report regarding the reason for an independence impairment.

* * *

Departures from the Applicable Financial Reporting Framework. Financial statements may contain departures from the applicable financial reporting framework (for example, income tax basis financial statements that fail to include an income tax provision). When departures are material, AU-C 800.14 refers auditors to the guidance in AU-C 705 for opinion modifications. AU-C 705.17 and .18 state that the standard audit report should be modified to express a qualified or adverse opinion. In such cases, a basis for modification paragraph should include a description of the matter giving rise to the modification and its financial effects, unless impracticable. If it is not practicable to quantify the financial effects, the auditor should state that fact in the paragraph. The opinion paragraph of the audit report should state, that except for the effects of the departure discussed in the basis for modification paragraph, the financial statements present fairly, in all material respects, the assets, liabilities, equity, revenues, and expenses in accordance with the special purpose framework described (in the case of a qualified

opinion) or that the financial statements do not present the entity's assets, liabilities, equity, revenues, and expenses fairly in accordance with the applicable financial reporting framework (in the case of an adverse opinion).

Inadequate disclosure is also considered a departure from the applicable financial reporting framework that could cause auditors to express a qualified or adverse opinion. In such cases, the audit report should be modified to include a basis for modification paragraph that either discloses the omitted information (provided that it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information) or explains the nature of the disclosure and states that management considers it impracticable to develop the information. In addition, the opinion paragraph should state that, except for the omission of the information discussed in the basis for modification paragraph, the financial statements present fairly the assets, liabilities, equity, revenues, and expenses in accordance with the applicable financial reporting framework (or, in the case of an adverse opinion, merely that the financial statements do not present the entity's assets, liabilities, equity, revenues, and expenses fairly in accordance with the applicable financial reporting framework). In practice, auditors rarely issue a qualified or adverse opinion due to inadequate disclosure since, at a minimum, the nature of the omitted disclosure must be described in the auditor's report even if the company objects to financial statement disclosure. However, there may be certain disclosure requirements that the company believes are not cost-beneficial to generate and, accordingly, auditors sometimes issue a qualified opinion in those circumstances.

Change in Accounting Principle. Auditors are not required to qualify their opinion because of a material change in accounting principle (or change in the method of applying an accounting principle) provided the change is accounted for properly and adequately disclosed in the financial statements. However, when the comparability of the financial statements is materially affected by the change, AU-C 708, *Consistency of Financial Statements*, requires the auditor to include an emphasis-of-matter paragraph in the auditor's report that describes the change in accounting principle and provides a reference to the entity's disclosure. The following is an example paragraph:

Change in Accounting Principle

As discussed in Note X to the financial statements, the Company changed its policy for determining cash equivalents in 20X1. Our opinion is not modified with respect to that matter.

The emphasis-of-matter paragraph should be repeated in subsequent years, as long as the year of change is presented and reported on. However, if an accounting change is accounted for by retrospective application, only the auditor's report for the year of change should include the explanatory paragraph, because in subsequent years all periods presented will be comparable.

Uncertainties about the Entity's Ability to Continue as a Going Concern. 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 disclosures in the financial statements. For each reporting period, FASB ASC 205-40-50-1 requires management to evaluate whether conditions or events indicate there is substantial doubt about the entity's ability to continue as a going concern for the year subsequent to the date the financial statements are issued or the date the financial statements are available to be issued. However, special purpose frameworks are not GAAP and such frameworks may not include an explicit requirement for management to evaluate the entity's ability to continue as a going concern for a reasonable period of time.

In February 2017, the Auditing Standards Board (ASB) issued SAS No. 132, AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, which supersedes, when effective, the current guidance at SAS No. 126 (AU-C 570A). Conceptually, the primary difference between SAS No. 132 and the existing guidance is that the new standard explicitly recognizes management's responsibility to consider going concern issues under GAAP and premises the auditor's procedures on that responsibility. It also clarifies the applicability of the standard when the financial statements are based on a financial reporting framework other than GAAP, such as a special purpose framework. While SAS No. 132 is effective for audits of financial statements for periods ending on or after December 15, 2017, because SAS No. 132 incorporates management's evaluation of whether aggregate conditions or events exist that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, it is believed that certain of the requirements would be performed prior to its effective date. Accordingly, the remainder of this discussion on going concern applies the guidance of AU-C 570.

According to AU-C 570.10, the auditor's objectives are to (a) obtain sufficient appropriate audit evidence about, and conclude on, the appropriateness of management's use of the going concern basis of accounting in preparing the financial statements, (b) conclude on whether substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time exists based on the audit evidence obtained, (c) evaluate possible effects on the financial statements, such as the adequacy of disclosure regarding an entity's ability to continue as a going concern for a reasonable period of time, and (d) issue an auditor's report in accordance with the auditing standard. The auditors' going concern assessment relates to a "reasonable period of time," which AU-C 570.11 defines as a period of time required by the applicable financial reporting framework or, if no such requirement exists, within one year after the date that the financial statements are available to be issued. Therefore, for special purpose framework financial statements, a reasonable period of time would be within one year after the date that the financial statements are available to be issued.

The requirements that auditors should follow to achieve the reporting-related objective (d) include—

- When the financial statements have been prepared using the going concern basis of accounting but the auditor believes the basis is inappropriate, express an adverse opinion (AU-C 570.23).
- Include an emphasis-of-matter paragraph when the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains after considering identified conditions or events and management's plans (AU-C 570.24).
- When expressing an emphasis-of-matter paragraph about the entity's ability to continue as a going concern, use terms consistent with the applicable financial reporting framework. (AU-C 570.25) (Do not use conditional language concerning the existence of substantial doubt about the entity's ability to continue as a going concern.)
- If there is inadequate disclosure about the entity's ability to continue as a going concern, express a qualified or adverse opinion, as appropriate, in accordance with AU-C 705 (AU-C 570.26).
- If management is unwilling to perform or extend its evaluation to meet the required time period under the applicable financial reporting framework, consider the implications on the auditor's report (AU-C 570.27).
- In comparative presentations, do not repeat the prior year emphasis-of-matter paragraph if substantial doubt has been removed in the current period (AU-C 570.29).
- Reassess the entity's going concern status if requested to reissue a report and eliminate a going concern emphasis-of-matter paragraph (AU-C 570.30).

When auditors conclude that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, AU-C 570.24–.26 require them to evaluate the adequacy of disclosures required by FASB ASC 205-40. If disclosures are adequate, auditors should express an unmodified opinion on the financial statements and disclose the uncertainty in an emphasis-of-matter paragraph of their report following the opinion paragraph. The following example presents such an emphasis-of-matter paragraph:

Going Concern

The financial statements have been prepared assuming that the Company will continue as a going concern. As indicated in Note X, there is substantial doubt about the Company's ability to continue as a going concern. [Or, Note X describes conditions and events that raise substantial doubt about the Company's ability to continue as a going concern.] The financial statements do not include any adjustments that might result from the outcome of that uncertainty. Our opinion is not modified with respect to that matter.

In certain situations, the emphasis-of-matter paragraph would not be retained. For example, when comparative financial statements are presented, a report on the current period statements may no longer need the going concern paragraph if the entity resolved the going concern uncertainty in the current year. In that situation, the auditor should not repeat the emphasis-of matter paragraph that was included in the prior year report. Another situation of when such a paragraph would not be retained could occur when the going concern uncertainty is

resolved after the auditor's report is issued. In that situation the auditor may be asked to reissue the auditor's report and eliminate the going concern emphasis-of-matter paragraph that was included in the original report.

If required disclosures are not made in the financial statements or such disclosures are inadequate, the auditor should express a qualified or adverse opinion, as appropriate, because of a departure from the applicable financial reporting framework. Additionally, best practices suggest that auditors include the emphasis-of-matter paragraph after the opinion paragraph of their report to highlight the going concern uncertainty.

Uncertainties Regarding Tax Positions. There may be circumstances when the proper tax treatment of a transaction or item entering into the tax calculation is unclear based on existing tax laws and court cases.

Expressing an Opinion on Prior-year Financial Statements That Is Different from the Opinion Previously Expressed. If auditors express an opinion on prior-period financial statements that differs from their previous opinion, the updated report should disclose all of the substantive reasons for the change in the opinion. Such disclosure should be made in an other-matter paragraph immediately following the opinion paragraph of the auditor's report. The paragraph should disclose—

- a. the date of the auditor's previous report,
- b. the type of opinion previously expressed,
- c. the substantive reasons that caused the auditors to express a different opinion, and
- d. the fact that the auditor's updated opinion on the prior-period financial statements is different from the previous opinion on those statements.

If the auditor's report on prior-period modified cash basis financial statements was modified because those statements were affected by a departure from the modified cash basis of accounting and the statements are restated in the current period to conform with the modified cash basis, the auditor's updated report on the prior-period statements should no longer be modified for that departure.

Group Audit Reporting Considerations. AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, addresses the special considerations that apply to an audit of group financial statements. Group financial statements include the financial information of more than one component, such as consolidated or combined financial statements. Among other things, AU-C 600.24 states that the group engagement partner should decide whether to make reference to a component auditor in the auditor's report on the group financial statements. Reference to the audit of a component auditor in the auditor's report on the group financial statements should not be made unless (AU-C 600.23 and AU-C 600.25–.26)—

- a. the component auditor meets independence requirements and there are no serious concerns about competence;
- b. the component's financial statements are prepared using the same financial reporting framework as the group financial statements or, if the financial reporting framework used by the component is different from that used by the group—
 - (1) the measurement, recognition, presentation, and disclosure criteria applicable to all material items in the component's financial statements are similar to those used in the group's financial statements, and
 - (2) the group auditor obtains sufficient audit evidence to evaluate the appropriateness of the adjustments needed to convert the component's statements to the framework used by the group without assuming responsibility for the component auditor's work;
- c. the component auditor has performed an audit of the financial statements of the component in accordance with GAAS or, when required by law or regulation, with auditing standards promulgated by the Public Company Accounting Oversight Board (PCAOB); and
- d. the component auditor has issued an auditor's report that is not restricted as to use.

AICPA Technical Q&A 8800.02 indicates that when there is more than one component auditor, the group auditor's decision to make reference is made individually for each component auditor. The group auditor may make reference to any, all, or none of the component auditors. When the group auditor decides to make reference to the work of a component auditor, AU-C 600.27 requires the group auditor to perform certain procedures to obtain audit evidence about the component, including reading the component's financial statements, the component auditor's report, and communicating with the component auditor. Typically, making reference to the work of a component auditor is done by modifying the Auditor's Responsibility section and the Opinion paragraph of the standard report. An example of those paragraphs with the modified language italicized follows:

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. *We did not audit the income tax basis financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets constituting 20% and 22%, respectively, of consolidated total assets at December 31, 20X1 and 20X0, and total revenues constituting 18% and 20%, respectively, of consolidated total revenues for the years then ended. Those income tax basis statements were audited by other auditors, whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.* We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, *based on our audit and the report of the other auditors*, the consolidated financial statements referred to in the first paragraph present fairly, in all material respects, the assets, liabilities, and stockholders' equity-income tax basis of ABC Company and its subsidiaries as of December 31, 20X1 and 20X0, and the results of their revenue and expenses and changes in stockholders' equity for the years then ended, in accordance with the basis of accounting ABC Company and its subsidiaries use for income tax purposes as described in Note A.

Change in Basis of Accounting. Companies sometimes change the basis of accounting used to present their financial statements from a special purpose framework to GAAP, from GAAP to a special purpose framework, or from one special purpose framework to another. However, Technical Q&A 9030.10 indicates that a change in basis of accounting is not a change in accounting principle as defined in FASB ASC 250-10-20. Nevertheless, AU-C 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*, allows auditors to include an emphasis-of-matter paragraph in the auditor's report to draw users' attention to a matter that is appropriately presented or disclosed in the financial statements when, in the auditor's professional judgment, it is of such importance that it is fundamental to users' understanding of the financial statements. In such circumstances, the emphasis-of-matter paragraph would state that the entity has changed the basis of accounting used to prepare the financial statements from one financial reporting framework to another. Best

practices also indicate that the paragraph may disclose that another report has been issued on the company's financial statements prepared in conformity with another financial reporting framework (such as when GAAP financial statements are issued in addition to cash basis financial statements). The following illustrates an emphasis-of-matter paragraph that may be added to the audit report to emphasize a change in the basis of accounting:

Basis of Accounting

We draw attention to Note X of the financial statements, which describes the basis of accounting. As described in Note X, in 20X2 the Company adopted a policy of preparing its financial statements on the modified cash basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America. The financial statements for 20X1 have been retrospectively adjusted to reflect the modified cash basis of accounting adopted in 20X2. Our opinion is not modified with respect to that matter.

Reporting When the Statement of Cash Flows Is Omitted. A statement of cash flows is not required in cash, modified cash, or income tax basis presentations. Therefore, an audit report on such financial statements would not need to be modified if the cash flow statement were omitted from the presentation. (If an entity chooses to present a statement of cash flows with its financial statements, however, that statement would be reported on as a basic financial statement rather than as supplementary information.)

Reporting on Supplementary Information

The following standards contain authoritative literature for additional information:

- AU-C 720, *Other Information in Documents Containing Audited Financial Statements*.
- AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*.
- AU-C 730, *Required Supplementary Information*.

The following paragraphs summarize important provisions of the AU-C 720 and AU-C 725.

Additional Information in Documents Containing Audited Financial Statements (Other Than Required Supplementary Information). Standards for the auditor's reporting responsibilities on other information (other than required supplementary information) are as follows:

- AU-C 720 applies to additional information in documents containing audited financial statements and the auditor's report when the auditor is *not* engaged to report on whether the information is fairly stated, in all material respects, in relation to the financial statements as a whole. *Other information* is the additional information, which can be "financial or nonfinancial information, that accompanies the financial statements, the auditor's report thereon, excluding required supplementary information. If the auditor is not engaged to report on other information, he or she has no responsibility for determining whether the information is properly stated, but should read the other information to identify material inconsistencies with the financial statements.
- AU-C 725 applies whenever the auditor is engaged to report on whether supplementary information presented with audited financial statements is fairly stated, in all material respects, in relation to the financial statements as a whole. *Supplementary information*, whether presented as a stand-alone document or in conjunction with the basic financial statements, is information presented that is not necessary for the financial statements to be in accordance with the applicable financial reporting framework.

Requirements for Reporting on Supplementary Information under AU-C 725. When the auditor is engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, AU-C 725.05 requires auditors to determine that the following conditions were met:

- The supplementary information (a) was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements, (b) relates to the same accounting period as the

financial statements, and (c) will accompany the entity's audited financial statements or those audited statements will be made readily available by the entity.

- The auditor issued an audit report on the financial statements that contained neither an adverse opinion nor a disclaimer of opinion on 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.

10. Ashleigh is hired to audit a company's income tax basis financial statements. She is satisfied with the financial statements as a whole, except for an immaterial inconsistency in how the company applied certain accounting principles. How should Ashleigh modify the auditor's report for this concern?
 - a. By adding a separate emphasis-of-matter paragraph.
 - b. Issue a disclaimer of opinion.
 - c. Issue an adverse opinion.
 - d. Issue a qualified opinion.
11. Which of the following statements regarding departures from the applicable financial reporting framework is correct?
 - a. Inadequate disclosure could cause auditors to express an adverse opinion.
 - b. The opinion paragraph should the omission of the information discussed in the basis for modification paragraph.
 - c. AU-C 705 refers auditors to the guidance in AU-C 800.14 for opinion modifications.
12. When auditors express an opinion on prior-period financial statements that differs from their previous opinion, the updated report should disclose all of the following immediately following the opinion paragraph **except**:
 - a. The auditor's previous report date.
 - b. The type of opinion that was previously expressed.
 - c. The substantive reasons that caused the auditors to change to a different opinion.
 - d. The auditor's responsibility.
13. Reference to the audit of a component auditor in the auditor's report on the group financial statements should not be made unless certain criteria are followed. Which of the following is **not** one of the criteria?
 - a. The component auditor meets independence requirements and there are no serious concerns about competence.
 - b. The component auditor has issued an auditor's report that is restricted as to use.
 - c. The component auditor has performed an audit of the financial statements of the component in accordance with GAAS.

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. Ashleigh is hired to audit a company's income tax basis financial statements. She is satisfied with the financial statements as a whole, except for an immaterial inconsistency in how the company applied certain accounting principles. How should Ashleigh modify the auditor's report for this concern? **(Page 38)**
- a. **By adding a separate emphasis-of-matter paragraph. [This answer is correct. For the inconsistency described above, Ashleigh could give an unmodified opinion if an emphasis-of-matter paragraph following the opinion paragraph is added to the standard auditor's report discussing the matter.]**
 - b. Issue a disclaimer of opinion. [This answer is incorrect. Auditors generally issue a disclaimer of opinion when a scope limitation is so significant that a qualified opinion is not appropriate.]
 - c. Issue an adverse opinion. [This answer is incorrect. This opinion would only be given if an auditor concludes that misstatements, individually or in the aggregate, from the special purpose framework are both material and pervasive to the financial statements.]
 - d. Issue a qualified opinion. [This answer is incorrect. Qualified opinions are issued when the auditor concludes that misstatements, individually or in the aggregate, are material but not pervasive to the financial statements, or the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.]
11. Which of the following statements regarding departures from the applicable financial reporting framework is correct? **(Page 40)**
- a. **Inadequate disclosure could cause auditors to express an adverse opinion. [This answer is correct. Inadequate disclosure is considered a departure from the applicable financial reporting framework that could cause auditors to express a qualified or adverse opinion.]**
 - b. The opinion paragraph should state that, the financial statements present fairly the assets, liabilities, equity, revenues, and expenses in accordance with the applicable financial reporting framework. [This answer is incorrect. The opinion paragraph should state that, except for the effects of the departure discussed in the basis for modification paragraph, the financial statements present fairly the assets, liabilities, equity, revenues, and expenses in accordance with the applicable financial reporting framework.]
 - c. AU-C 705 refers auditors to the guidance in AU-C 800.14 for opinion modifications. [This answer is incorrect. When departures are material, AU-C 800.14 refers auditors to the guidance in AU-C 705 for opinion modifications.]
12. When auditors express an opinion on prior-period financial statements that differs from their previous opinion, the updated report should disclose all of the following immediately following the opinion paragraph **except: (Page 42)**
- a. The auditor's previous report date. [This answer is incorrect. According to AU-C 800, the paragraph should disclose the date of the auditor's report.]
 - b. The type of opinion that was previously expressed. [This answer is incorrect. The report should disclose the type of opinion previously expressed per AU-C 800.]
 - c. The substantive reasons that caused the auditors to change to a different opinion. [This answer is incorrect. As stated in AU-C 800, the reports should disclose the substantive reasons that caused the auditors to express a different opinion.]
 - d. **The auditor's responsibility. [This answer is correct. The auditor's responsibilities are disclosed in the auditor's responsibility paragraphs preceding the opinion paragraph.]**

13. Reference to the audit of a component auditor in the auditor's report on the group financial statements should not be made unless certain criteria are followed. Which of the following is **not** one of the criteria? **(Page 42)**
- a. The component auditor meets independence requirements and there are no serious concerns about competence. [This answer is incorrect. According to AU-C 600.23 and AU-C 600.25–.26, reference to the audit of a component auditor in the auditor's report on the group financial statements should not be made unless the component auditor meets independence requirements and there are no serious concerns about competence.]
 - b. The component auditor has issued an auditor's report that is restricted as to use. [This answer is correct. According to AU-C 600.23 and AU-C 600.25–.26, reference to the audit of a component auditor in the auditor's report on the group financial statements should not be made unless the component auditor has issued an auditor's report that is not restricted as to use.]**
 - c. The component auditor has performed an audit of the financial statements of the component in accordance with GAAS. [This answer is incorrect. According to AU-C 600.23 and AU-C 600.25–.26, reference to the audit of a component auditor in the auditor's report on the group financial statements should not be made unless the component auditor has performed an audit of the financial statements of the component in accordance with GAAS or, when required by law or regulation, with auditing standards promulgated the component auditor has issued an auditor's report that is not restricted as to use.]

OTHER REPORTING SITUATIONS

Reporting on Regulatory Basis Financial Statements

AU-C 800 defines the accounting basis that a reporting entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject as a special purpose framework. When reporting on financial statements that are prepared in conformity with such a regulatory basis, the appropriate form of report depends on the intended use of the report. AU-C 800 allows auditors to report on regulatory basis financial statements as special purpose framework financial statements if the statements and report are intended to be used solely by parties within the entity and by one or more regulatory agencies. (Such a report is appropriate if the regulatory authorities make the financial statements a matter of public record.) If the regulatory basis financial statements are intended for general use, the auditor's report should (a) express an opinion on whether the financial statements are in accordance with GAAP and (b) express an opinion in a separate paragraph about whether the financial statements are prepared in accordance with the regulatory basis of accounting.

Intended Solely for Regulatory Filing. As previously noted, if regulatory basis financial statements are intended to be used solely by parties within the entity and by one or more regulatory agencies, the auditor can report on them as special purpose framework financial statements. However, AU-C 800.20 indicates that a paragraph restricting use of the report to those within the company and one or more regulatory agencies should be added.

The basis of accounting paragraph states the basis of presentation, indicating that it is a basis of accounting other than accounting principles generally accepted in the United States of America, and refers to the note to the financial statements that describes the basis. The opinion paragraph expresses the auditor's opinion about whether the financial statements are presented in conformity with the regulatory basis of accounting. If the auditors conclude that the financial statements are not presented fairly on the regulatory basis, they should disclose their reasons for that conclusion in a separate paragraph under an appropriate heading such as "Basis for Qualified Opinion" preceding the opinion paragraph of the report. The heading for the opinion paragraph would also be modified to something such as "Qualified Opinion" and the opinion paragraph would be modified to refer to the basis for qualified opinion paragraph. An emphasis-of-matter paragraph should be included stating the basis of presentation and indicating that it is a basis of accounting other than GAAP and refer to the note to the financial statements that describes the basis. That paragraph also should describe the purpose for which the financial statements are prepared or refer to a note to the financial statements that contains that information. In addition, the report includes an other-matter paragraph restricting the report's use (which is appropriate even though the auditor's report may, by law or regulation, become a matter of public record).

Not Limited to Use in Regulatory Filings. AU-C 800.21 provides guidance on the form of reporting for financial statements prepared on a basis of accounting prescribed by a regulatory agency when the financial statements will not be limited to use in regulatory filings (in other words, intended for general use). When the regulatory basis contains departures from GAAP, the auditor's report would be the standard form of report, modified (i.e., a qualified or adverse opinion) because of the prescribed GAAP departures. The report also should include an additional paragraph that expresses an opinion on whether the financial statements are in conformity with the prescribed basis of accounting. This type of reporting is used when:

- a. the financial statements and report are intended for use by parties other than those within the entity and one or more regulatory agencies to whose jurisdiction the entity is subject, or
- b. the financial statements and report are distributed (either voluntarily or upon specific request) by the entity to parties other than the regulatory agencies to whose jurisdiction the entity is subject.

AICPA Audit and Accounting Guide, *Property and Liability Insurance Entities*, Paragraph 10.37, provides similar guidance on the form of report when auditors are requested to report on an insurance company's financial statements that are prepared in conformity with the basis of accounting used to comply with requirements of a regulatory agency and that are not limited to use in regulatory filings.

When an adverse opinion is issued, AU-C 705 states that auditors should disclose the financial effect of the subject matter on the company's financial position, results of operations, and cash flows in a basis for modification

paragraph of their report, if reasonably determinable, immediately preceding the opinion paragraph. If it is not practicable to quantify the effects of the departure, the basis for modification paragraph should indicate that fact and state that the differences are presumed to be material. AU-C 705.A21 states that requirement may be met by referring to a note to the financial statements that discloses the effects required by AU-C 800.21. The last paragraph of the report should express an unmodified opinion on the presentation of the financial statements in accordance with the regulatory basis of accounting. However, the report does not include an other-matter paragraph restricting the use of the report.

Considerations for Compilations and Reviews. AR-C 80.20b and AR-C 90.42b stipulate that compilation and review reports for regulatory basis financial statements should describe the purpose for which the financial statements are prepared, or refer to a note in the financial statements that provides such information. AR-C 80.A32 and AR-C 90.A84 further explain that this is necessary to help avoid misunderstandings when such financial statements are used for purposes other than that for which they were intended.

IRS Form 990

Audits. Some states allow charitable organizations to use IRS Form 990, "Return of Organizations Exempt from Income Tax," as a uniform annual report for reporting to both state and federal governments, and some of those states require Form 990 to be accompanied by an auditor's report on the financial statements included in the form. The form of auditor's report depends on (a) whether the financial statements presented in Form 990 are in conformity with GAAP and (b) the report's intended use.

If the financial statements included in Form 990 are in conformity with GAAP (including appropriate note disclosures), auditors would issue a standard AU-C 700 report with an unmodified opinion. However, financial statements included in Form 990 often contain certain material departures from GAAP for such organizations. In those situations, the appropriate form of report is determined by the intended use of the report as discussed in the following paragraphs.

Financial Statements Intended Solely for Filing with Regulatory Agency. When financial statements presented on Form 990 contain material GAAP departures required by a state agency, the report form for a regulatory basis of accounting, as discussed earlier in this section, is appropriate only if the financial statements will be used solely for filing with the regulatory agency (including those situations in which, by law or regulation, the report may be made a matter of public record). In addition, the report would include an other-matter paragraph restricting the use of the auditor's report. Such a regulatory basis report is not modified for a lack of disclosures. To issue such an unmodified regulatory basis report for the financial statements included in Form 990, best practices indicate that appropriate disclosures must be attached to the Form 990.

Financial Statements Intended for Distribution to Others. If Form 990 will be used for purposes other than regulatory filings (for example, copies of Form 990 are distributed to contributors or others), the regulatory basis report form, discussed earlier, is not appropriate. In those cases, auditors should express a qualified or adverse opinion on the financial statements because of the departures from GAAP and, if reasonably determinable, disclose the effects of the GAAP departures on the financial statements. Otherwise, the report should state the effects are not reasonably determinable. AU-C 800.21 states auditors should add a paragraph expressing an opinion on conformity with the prescribed basis of accounting.

Considerations for Compilations and Reviews. 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. AR-C 90.A1 also states that the accountant may be engaged to review financial information included in a tax return.

Contractual Basis of Accounting

Audits. AU-C 800.07 defines the *contractual basis of accounting* as “a basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the auditor.” AU-C 800 includes specific additional requirements when reporting on contractual basis financial statements.

- AU-C 800.16 states that the auditor should evaluate whether contractual basis financial statements adequately disclose any significant interpretations of the underlying contract upon which the financial statements are based.
- AU-C 800.18a states that the auditor’s report should make reference to management’s responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances whenever management has a choice of financial reporting frameworks. Best practices indicate that it would be assumed that management did not have a choice of financial reporting frameworks if the financial statements are prepared on the contractual basis of accounting.
- AU-C 800.18b states that the auditor’s report should describe the purpose for which the contractual basis financial statements were prepared or refer to a financial statement note with that information.
- AU-C 800.20 states that contractual basis financial statements should include an other-matter paragraph that restricts the use of the auditor’s report to the entity and parties to the underlying contract.

As in any audit, the auditor should modify his or her opinion if either (a) the practitioner concludes that the financial statements are not presented fairly in conformity with the prescribed basis of accounting or (b) there has been a limitation on the scope of the audit. The auditor’s opinion should also be modified in those situations that would require it in any audit of financial statements, such as lack of consistency or revisions of previous opinion on prior-year financial statements presented in comparative form. Other reporting standards also need to be followed, as appropriate in the circumstances.

Reviews. A review of contractual basis financial statements should be done performed in accordance with AR-C 80. The accountant should generally apply the same procedures as for a review of GAAP financial statements. Additional reporting requirements The review specific to reviewed special purpose financial statements, including contractual basis, are located in AR-C 90.40–.44.

Compilations. A compilation of contractual basis financial statements should be performed in accordance with AR-C 80. The accountant should generally apply the same procedures as for a compilation of GAAP financial statements. Additional reporting requirements specific to compiled special purpose financial statements, including contractual basis, are located in AR-C 80.18–.21.

In a compilation engagement, the client may choose to omit substantially all of the financial statement disclosures. In that case, the accountant’s report should include the “Management has elected to omit . . .” paragraph described in AR-C 80.27.

Prescribed Forms

Accountants may be engaged to report on financial information presented in prescribed forms or schedules. Such forms include any standard preprinted form designed or adopted by the entity to which it is to be submitted or filed. Examples include forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies, other than those concerned with the sale or trading of securities. However, a form designed or adopted by the reporting entity is not considered a prescribed form. For example, a reporting package designed by a company for use in gathering financial statements for subsidiaries, divisions, or store locations is not a prescribed form. In addition, a comprehensive set of instructions not associated with a standard preprinted form does not constitute a prescribed form. Also, tax returns are not considered prescribed forms. In this discussion, the entity whose financial results are presented in the form is referred to as the *reporting entity* and the entity to which the form is to be submitted or filed is referred to as the *requesting entity*.

Determining the Basis of Accounting. If the prescribed form does not specify the accounting basis, the basis normally used by the company appears to be the most appropriate basis on which to prepare the financial statements included in the form. For instance, a professional corporation that has adopted the cash basis of accounting should apply cash basis principles unless the form specifically requests otherwise. The authors suggest that when deciding which basis of accounting to use, the accountant weigh the objectives of the body prescribing the form, the difficulties of producing GAAP financial statements, and the special reporting considerations for special purpose financial statements.

Compilations. The SSARS do not specifically address reporting on financial statements to be included in a prescribed form. The AICPA Guide, however, does provide some guidance on engagements to compile or prepare financial statements in accordance with a prescribed format.

Best practices indicate that most prescribed form engagements are either performed as financial statement preparation engagements or compilation engagements. Both preparation and compilation are levels of service that provide *no assurance*. This discussion on prescribed forms primarily addresses prescribed form compilation engagements. Information on performing a financial statement preparation engagement is discussed in *PPC's Guide to Compilation and Review Engagements*.

This discussion considers at how to apply the nonauthoritative guidance on prescribed forms in the AICPA Guide when the reporting entity uses a special purpose framework. The threshold question is whether a reporting entity that uses a special purpose framework to prepare its other financial statements for external use can use that same framework to prepare financial statements included in a prescribed form. For example, if the reporting entity prepares its income tax returns using the cash basis and uses that same basis to prepare its financial statements, can it also use that basis to complete a prescribed form? Does the answer depend on whether it is obvious the form assumes an accrual basis?

As a practical matter, many, and perhaps most, requesting entities are not likely to be familiar with the notion of using frameworks other than *generally accepted* accounting principles to prepare financial statements. Many prescribed forms have standard accruals as preprinted line items, which indicate that the requesting entity has in mind an accrual basis presentation. Prescribed forms that request information about financial position also typically have a line item for other assets and one for other liabilities.

Leaving key line items blank, such as accounts receivable and accounts payable, may lead to questions from the requesting entity and may ultimately lead to rejection of the form. Best practices, therefore, indicate that a special purpose framework used for other external financial reporting can be used to prepare financial statements included in a prescribed report, but key line items in the form that would not be recognized under that framework should be completed if they are applicable to the reporting entity's operations.

For example, an entity that uses the cash basis for tax reporting could use that same framework to prepare a prescribed form but significant accruals called for by the form should be completed as well. However, those accruals should be treated as departures from the framework that are called for by the form. How should those accruals be measured? For example, should accounts receivable be reported at the amount outstanding or their net realizable value? The form is not likely to provide guidance, so professional judgment is required. Best practices suggest requesting entities typically want accounts receivable reported at the amount of cash likely to be collected. Yet, if the cash income tax basis is used, it would also be reasonable to report accounts receivable at the amount outstanding because that is how accounts receivable would be measured under the accrual income tax basis.

AR-C 80 requires disclosure of the primary differences between the special purpose framework and GAAP. Prescribed forms rarely ask for such information, and the absence of that disclosure is because the prescribed form is silent on whether disclosures other than those in the form are required. Due to the presumption that the information required by a prescribed form is sufficient to meet the needs of the requesting entity (see the AICPA Guide, Paragraph 2.82), there is no need to mention the absence of that disclosure in the report. However, if the financial statements include departures from the applicable financial reporting framework that are not required by the prescribed form, then a departure from the applicable financial reporting framework results. The discussion earlier in this lesson addresses reporting in that situation.

AR-C 80 does not require compilation reports on financial statements included in a prescribed form to include a paragraph restricting the use of the report to the intended specified parties. However, Paragraph 2.84 of the AICPA

Guide indicates that due to the nature of such financial statements and the potential for the report to be misunderstood, accountants may decide to restrict the use of the accountant's compilation report on financial statements prepared in accordance with a prescribed format. Best practices suggest restricting the use of reports on prescribed form financial statements.

Prescribed forms often include a preprinted space for the CPA to sign, typically accompanied by reporting language that does not comply with authoritative literature. Best practices indicate that the CPA should not sign the preprinted space but should instead include a reference such as "see the attached accountant's compilation report" and attach the report to the form. This position is consistent with the guidance in the AICPA Guide, Paragraph 2.85.

Many forms have spaces for information that is not included in financial statements, such as number of clients served. Best practices suggest including a paragraph in the report stating that the CPA is assuming no responsibility for that information.

Reviews. Best practices indicate that a review engagement generally would not be appropriate for financial statements included in a prescribed form since a review report is not available for financial statements that omit substantially all disclosures, as is often the case with prescribed forms. Therefore, a review report would not be a practical option since each departure from the applicable financial reporting framework and each omitted financial statement disclosure would need to be described in the review report. However, if the prescribed form simply calls for financial statements that are in accordance with GAAP or a special purpose framework, then a review engagement in accordance with AR-C 90 would be an appropriate viable option.

Audits. Auditors may be engaged to report on special purpose framework financial information presented in prescribed forms or schedules. However, such forms often prescribe wording for the auditor's report that is unacceptable to auditors because it does not conform to applicable professional reporting standards. For example, the prescribed language of the report may call for assertions by the auditors that are not consistent with their function or responsibility or that the auditors have no basis to make. AU-C 800.23 states that some report forms may be made acceptable by inserting wording, while others may be made acceptable only by complete revision. When a prescribed form calls on auditors to make an assertion that they believe they are not justified in making, they should reword the prescribed form of report or attach a separate report.

Titles. Unmodified titles such as "Balance Sheet" and "Statement of Income" generally are not suitable for special purpose framework financial statements. Therefore, in some situations it may be appropriate for the accountants to alter the titles on a prescribed form to conform to appropriate statement titles. In that case, the accountant's or auditor's report should refer to the altered titles as they appear on the prescribed form. In practice, however, the titles on the form usually are not changed, and the accountant's or auditor's report on the statements uses the preprinted titles.

SELF-STUDY QUIZ

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

14. Which of the following statements regarding the use of IRS Form 990 is correct?
- a. If the financial statements of an allowable charitable organization included in Form 990 are in conformity with GAAP, auditors would issue a standard AU-C 70 report with a qualified opinion.
 - b. The report form for a regulatory basis of accounting is appropriate only if the financial statements will be solely used for filing with the regulatory agency when financial statements presented on Form 990 contain GAAP departures required by a state agency.
 - c. Auditors should use the regulatory basis report form when Form 990 is used for purposes other than regulatory filings.
 - d. Form 990 is not considered a tax return for SSARS purposes.
15. Which of the following states that the auditor should describe the purpose for which the financial statements were prepared?
- a. AU-C 800.16.
 - b. AU-C 800.18a.
 - c. AU-C 800.18b.
 - d. AU-C 800.20.
16. Which of the following statements regarding specific items included in certain prescribed forms is correct?
- a. Accountants are encouraged to perform a review engagement for financial statements included in a prescribed form.
 - b. In some instances, prescribed forms often propose wording for the auditor's report that does not conform to applicable professional reporting standards.
 - c. Authoritative literature states that accountants should include unmodified titles to special purpose 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.)**

14. Which of the following statements regarding the use of IRS Form 990 is correct? **(Page 51)**

- a. If the financial statements of an allowable charitable organization included in Form 990 are in conformity with GAAP, auditors would issue a standard AU-C 70 report with a qualified opinion. [This answer is incorrect. If the financial statements included in Form 990 are in conformity with GAAP (including appropriate note disclosures), auditors would issue a standard AU-C 700 report with an unmodified opinion. However, financial statements included in Form 990 often contain certain material departures from GAAP for such organizations.]
- b. The report form for a regulatory basis of accounting is appropriate only if the financial statements will be solely used for filing with the regulatory agency when financial statements presented on Form 990 contain material GAAP departures required by a state agency. [This answer is correct. When financial statements presented on Form 990 contain GAAP departures required by a state agency, the report form for a regulatory basis of accounting is appropriate only if the financial statements will be used solely for filing with the regulatory agency (including those situations in which, by law or regulation, the report may be made a matter of public record).]**
- c. Auditors should use the regulatory basis report form when Form 990 is used for purposes other than regulatory filings. [This answer is incorrect. If Form 990 will be used for purposes other than regulatory filings (for example, copies of Form 990 are distributed to contributors or others), the regulatory basis report form is not appropriate. In those cases, auditors should express a qualified or adverse opinion on the financial statements because of the departures from GAAP and, if reasonably determinable, disclose the effects of the material GAAP departures on the financial statements. Otherwise, the report should state the effects are not reasonably determinable.]
- d. Form 990 is not considered a tax return for SSARS purposes. [This answer is incorrect. In addition to income tax returns, information returns such as Form 990 and Form 5500 are considered tax returns for purposes of the SSARS.]

15. Which of the following states that the auditor should describe the purpose for which the financial statements were prepared? **(Page 52)**

- a. AU-C 800.16. [This answer is incorrect. AU-C 800.16 states that the auditor should evaluate whether contractual basis financial statements adequately disclose any significant interpretations of the underlying contract upon which the financial statements are based.]
- b. AU-C 800.18a. [This answer is incorrect. AU-C 800.18a states that the auditor's report should make reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances whenever management has a choice of financial reporting frameworks.]
- c. AU-C 800.18b. [This answer is correct. AU-C 800.18b states that the auditor's report should describe the purpose for which the contractual basis financial statements were prepared or refer to a financial statement note with that information.]**
- d. AU-C 800.20. [This answer is incorrect. AU-C 800.20 states that contractual basis financial statements should include an other-matter paragraph that restricts the use of the auditor's report to the entity and parties to the underlying contract.]

16. Which of the following statements regarding specific items included in certain prescribed forms is correct?
(Page 54)
- a. Accountants are encouraged to perform a review engagement for financial statements included in a prescribed form. [This answer is incorrect. According to best practices, a review engagement generally would not be appropriate for financial statements included in a prescribed form since a review report is not available for financial statements that omit substantially all disclosures, as is often the case with prescribed forms.]
 - b. In some instances, prescribed forms often propose wording for the auditor's report that does not conform to applicable professional reporting standards. [This answer is correct. Auditors may be engaged to report on special purpose framework financial information presented in prescribed forms or schedules. However, such forms often prescribe wording for the auditor's report that is unacceptable to auditors because it does not conform to applicable professional reporting standards.]**
 - c. Authoritative literature states that accountants should include unmodified titles to special purpose financial statements. [This answer is incorrect. Unmodified titles such as "Balance Sheet" and "Statement of Income" generally are not suitable for special purpose framework financial statements. Therefore, in some situations it may be appropriate for the accountants to alter the titles on a prescribed form to conform to appropriate statement titles. In that case, the accountant's or auditor's report should refer to the altered titles as they appear on the prescribed form.]

Personal Financial Statements

CPAs are frequently asked to provide services in connection with personal financial statements for use in obtaining credit, for income tax planning, retirement planning, or gift and estate planning purposes, or for public disclosure by candidates for public office. 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.

Personal financial statements may be prepared on one of the following bases:

- a. *Cash Basis*. Using the *pure* cash basis, the only asset reflected on the financial statement is cash, 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 current value basis.
- c. *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.
- d. *Income Tax Basis*. Assets and liabilities under the income tax basis are measured in accordance with the principles the individual uses for federal or other income tax reporting.

The following paragraphs provide guidance for reporting on compiled or reviewed personal financial statements prepared using a comprehensive basis of accounting other than GAAP. When audited personal financial statements are prepared using an historical cost basis, best practices suggest that they be reported on in the same manner as financial statements prepared following the guidance in AU-C 800.

Compilation and Review Reports. Compilations and reviews of personal financial statements prepared in conformity with a special purpose framework like other such engagements, are subject to both the performance and reporting requirements of the SSARS.

The form and substance of a compilation or review report issued in connection with personal financial statements prepared using a special purpose framework would not differ from such reports issued for commercial entities. Nevertheless, subtle differences in wording are caused by the nature of the engagement. For instance, the financial statement titles in reports on personal financial statements would typically be different [e.g., "Statement of Assets and Liabilities—Income Tax (Historical Cost) Basis" and, if presented, "Statement of Changes in Net Assets—Income Tax (Historical Cost) Basis"]. In addition, the example reports in the AICPA Guide (a) identify the individuals (rather than the company) about whom the financial statements are prepared; (b) note that the representations are those of the individuals instead of management of a company; and (c) in a review, note 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 accountants to issue a compilation report on financial statements that omit substantially all disclosures by adding a paragraph to the standard compilation report. That option is available also for personal financial statements, *except there is one additional reporting item*. 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, best practices suggest that the accountant include the following sentence as the second sentence 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, it is generally believed to be 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 does not allow such assurances.

Personal Financial Statements Included in Written Personal Financial Plans. AR-C 70.01 indicates 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.

Specified Elements, Accounts, or Items of a Financial Statement

Authoritative guidance for reporting on an audit of specified elements, accounts, or items of a financial statement is contained in AU-C 805, *Special Considerations—Audits of Single Financial Statement and Specific Elements, Accounts, or Items of a Financial Statement*. According to AU-C 805, an accountant can audit a specified element of a financial statement that is presented separately, i.e., not presented as supplementary information with financial statements. Agreed-upon procedures under the guidance in AT-C 215, *Agreed-Upon Procedures*, may also be applied. Detailed information on reporting on a specified element, account, or item of a financial statement under the auditing or attestation standards can be found in *PPC's Guide to Auditor's Reports* and *PPC's Guide to Nontraditional Engagements*.

In addition to the above alternatives, the accountant may compile or review a presentation of a specified element of a financial statement in accordance with AR-C 80 and AR-C 90, respectively. AR-C 80.01 and AR-C 90.01 indicate that AR-C 80 and AR-C 90 apply to engagements to compile and review historical information other than financial statements. In addition, AR-C 80.A3 and AR-C 90.A2 list specified elements as types of historical financial information to which the guidance in AR-C 80 and AR-C 90 applies. When the accountant is engaged to compile one or more specified elements, accounts, or items of a special purpose framework financial statement, the report should include the required elements listed at AR-C 80.17 (previously discussed in this lesson under "Required Elements of Compilation Reports") as modified for a specified element engagement. When the accountant is engaged to review one or more specified elements, accounts, or items of a special purpose framework financial statement, the report should include the required elements listed at AR-C 90.39 and AR-C 90.40–.44 (previously discussed in this lesson under "Required Elements of Review Reports") as modified for a specified element engagement.

If the specified element, account, or item of a financial statement is a schedule presented with financial statements, i.e., not presented separately, the schedule could be treated as a supplementary schedule that the accountant reviewed or compiled, or did not review or compile in relation to the financial statements taken as a whole.

SELF-STUDY QUIZ

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

17. The term personal financial statements refers to all of the following **except**:
- a. Financial statements that present group personal assets and liabilities.
 - b. Financial statements that present the financial positions of a partnership.
 - c. Financial statements that present liabilities of a group of related individuals.
18. In preparing personal financial statements, which of the following bases is measured in accordance with the principles the individual uses for federal income tax reporting?
- a. Modified cash basis.
 - b. Historical cost basis.
 - c. Cash basis.
 - d. Income tax basis.
19. Which of the following statements regarding the following sentence included in personal financial statements is correct?
- The financial statements are *intended to present* the assets of Nick and Robin Thompson at estimated current values and their liabilities at estimated current amounts.
- a. The sentence is required.
 - b. Best practices suggest that accountants include this sentence as the first sentence of the first paragraph of the compilation report.
 - c. It is necessary to include the phrase *intended to* in the sentence.
20. Which of the following is true regarding personal financial statements included in written personal financial plans?
- a. Requirements of AR-C 70 apply to personal financial statements included in written personal financial plans.
 - b. The client may engage the accountant to audit the financial statements in accordance with AR-C 80.
 - c. If primarily intended for third party use, the accountant may prepare the statements in accordance with AR-C 70.
 - d. Accountants are required to prepare financial statements for personal financial plans.
21. Which of the following accurately describes treatment of specified elements, accounts, or items of a financial statement?
- a. Authoritative audit guidance is contained in AU-C 930.
 - b. If presented separately, a specified element cannot be audited.
 - c. Agreed-upon procedures cannot be applied.
 - d. Accountants may compile a presentation of a specified element.

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. The term personal financial statements refers to all of the following **except: (Page 58)**

- a. Financial statements that present group personal assets and liabilities. [This answer is incorrect. According to AU-C 800, the term *personal financial statements* refer to financial statements that present the personal assets and liabilities of an individual.]
- b. Financial statements that present the financial positions of a partnership. [This answer is correct. This term does not include financial statements presenting the financial position or results of operations of unincorporated business enterprises such as proprietorships or partnerships.]**
- c. Financial statements that present liabilities of a group of related individuals. [This answer is incorrect. The term personal financial statements refer to financial statements that present the personal liabilities and assets of a group of related individuals (a family), per AU-C 800.]

18. In preparing personal financial statements, which of the following bases is measured in accordance with the principles the individual uses for federal income tax reporting? **(Page 58)**

- a. Modified cash basis. [This answer is incorrect. 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 historical cost basis or the current value basis.]
- b. Historical cost basis. [This answer is incorrect. The historical cost basis generally measures the individual's assets and liabilities in accordance with GAAP for reporting entities other than individuals.]
- c. Cash basis. [This answer is incorrect. Using the pure cash basis, the only asset reflected on the financial statement is cash, no liabilities, and only cash receipts and disbursements are reported as increases and decreases in net assets.]
- d. Income tax basis. [This answer is correct. Assets and liabilities under the income tax basis are measured in accordance with the principles the individual uses for federal or other income tax reporting.]**

19. Which of the following statements regarding the following sentence included in personal financial statements is correct? **(Page 58)**

The financial statements are *intended to present* the assets of Nick and Robin Thompson at estimated current values and their liabilities at estimated current amounts.

- a. The sentence is required. [This answer is incorrect. Although this sentence is not required, it is generally believed to be important in describing the applicable financial reporting framework and would still be included when substantially all disclosures are omitted.]
- b. Best practices suggest that accountants include this sentence as the first sentence of the first paragraph of the compilation report. [This answer is incorrect. Best practices recommend including the sentence as the second sentence of the first paragraph of the compilation report.]
- c. It is necessary to include the phrase *intended to* in the sentence. [This answer is correct. 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 does not allow such assurances.]**

20. Which of the following is true regarding personal financial statements included in written personal financial plans? **(Page 59)**
- a. Requirements of AR-C 70 apply to personal financial statements included in written personal financial plans. [This answer is incorrect. AR-C 70.01 indicates 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 prepared by the accountant.]
 - b. The client may engage the accountant to audit the financial statements in accordance with AR-C 80. [This answer is incorrect. If the financial statements are primarily intended for third party use, the client may choose to engage the accountant to compile them in accordance with AR-C 80.]
 - c. **If primarily intended for third party use, the accountant may prepare the statements in accordance with AR-C 70. [This answer is correct. 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.]**
 - d. Accountants are required to prepare financial statements for personal financial plans. [This answer is incorrect. The decision about whether the accountant prepares or compiles financial statements for personal financial plans partially depends on the accountant's willingness to prepare such statements.]
21. Which of the following accurately describes treatment of specified elements, accounts, or items of a financial statement? **(Page 59)**
- a. Authoritative audit guidance is contained in AU-C 930. [This answer is incorrect. Authoritative guidance for reporting on an audit of specified elements, accounts, or items of a financial statement is contained in AU-C 805, *Special Considerations—Audits of Single Financial Statement and Specific Elements, Accounts, or Items of a Financial Statement*.]
 - b. If presented separately, a specified element cannot be audited. [This answer is incorrect. According to AU-C 805, an accountant can audit a specified element of a financial statement that is presented separately, i.e., not presented as supplementary information.]
 - c. Agreed-upon procedures cannot be applied. [This answer is incorrect. Under the guidance in AT-C 215, agreed upon procedures may also be applied to specified elements, accounts, or items of a financial statement.]
 - d. **Accountants may compile a presentation of a specified element. [This answer is correct. In addition to auditing, the accountant may compile or review a presentation of a specified element of a financial statement in accordance with AR-C 80 and AR-C 90.]**

Lesson 3: Interim Engagements

INTRODUCTION

Accountants who perform annual compilation, review, and audit engagements often also perform interim engagements for their clients. It is believed that compilation and review services are the primary financial statement services provided for interim financial statements prepared using a special purpose framework. Accordingly, this lesson primarily focuses on the professional requirements of compilation and review engagements. In some instances, an accountant may be engaged to perform an AR-C 70 financial statement preparation engagement instead of a compilation or a review. Financial statement preparation engagements are only minimally discussed in this lesson, but are included in PPC's Guide to SSARS Preparation Engagements.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify unique issues in preparing interim financial statements using a special purpose framework and reporting on those statements.

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 either has been engaged to audit the entity's current year financial statements or audited the entity's latest annual financial statements 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*. When the conditions listed above are not met, 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 reviewing interim financial statements in accordance with AU-C 930.

This lesson discusses some unique issues in preparing interim financial statements using a special purpose framework and reporting on those statements.

ACCOUNTING CONSIDERATIONS FOR INTERIM FINANCIAL STATEMENTS

When preparing interim financial statements using special purpose framework, guidance for recognizing and measuring transactions in annual financial statements for the relevant basis of accounting is generally applicable. The remainder of this lesson presents general guidelines for preparing interim financial statements as well as addressing certain unique interim reporting situations.

Revenues and Expenses

Revenue from products sold or services rendered should be recognized on the same basis as followed for the full year. Adjustments should not be made to annualize seasonal revenue. However, as discussed and illustrated later in this lesson, in financial statements that do not omit substantially all disclosures, companies should disclose the seasonal nature of the company's business.

Procedures adopted for assigning specific cost and expense items to an interim period should generally be consistent with the basis of accounting followed by the company in reporting operating results 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, best practices indicate that, following the general guidance in FASB ASC 270-10-45-4 for interim GAAP financial statements, the cost or expense item may be allocated to those interim periods. If full disclosure financial statements are prepared, best practices suggest that this accounting treatment be disclosed.

Inventories

When preparing interim financial statements, some entities encounter difficulties with inventory valuation and the related effect on cost of goods sold. Ordinarily, it is not feasible for small and midsize entities to obtain inventory values by physical count at interim financial statement dates. For GAAP financial statements, FASB ASC 270-10-45-6 offers some relief by allowing use of some methods of estimating inventory. Therefore, best practices indicate that similar relief is appropriate for interim special purpose financial statements. The following paragraphs discuss some of these inventory-related problem areas and offer guidance.

Gross Profit Method. The gross profit method, commonly used for estimating inventories and cost of goods sold at interim dates when physical inventories are not taken, is an acceptable method for use in interim GAAP financial statements under FASB ASC 270-10-45-6. (This method is not acceptable in *annual* GAAP statements.) Best practices indicate that the same guidance is appropriate for special purpose framework financial statements. However, consistent with the FASB ASC 270-10-45-6 requirements for interim GAAP financial statements, Best practices indicate that the use of estimated gross profit rates should be disclosed in interim special purpose framework financial statements that do not omit substantially all disclosures.

Although best practices indicate that most cash basis entities will not have significant inventories, an entity may occasionally choose to modify the pure cash basis to record inventories. Such entities may choose to use the gross profit method for estimating inventories at interim dates when physical inventories are not taken. An example of a disclosure of the use of the gross profit method for modified cash basis interim financial statements would be as follows:

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.

Application of the gross profit method should reflect the method used to value inventories; for example, the gross profit percentage used to apply the method will differ depending on whether FIFO or LIFO is used.

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. When an estimation technique has been used, this fact should be disclosed along with a description of the technique unless the financial statements omit substantially all disclosures.

Some companies only compute LIFO inventory values annually and value interim inventories on a FIFO basis. In these circumstances, 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 operating results on a non-LIFO basis constitutes presentation of annual results on a non-LIFO basis.

Capitalization of Indirect Costs. IRC Sec. 263A requires that certain indirect costs be allocated to inventory valued at cost for entities using the income tax basis of accounting. Best practices indicate that this requirement also applies to interim income tax basis financial statements. (The IRC exempts resellers of personal property from

IRC Sec. 263A's requirements if average annual gross receipts for the previous three tax years are \$10 million or less.)

Depreciation

If depreciation expense is recognized, such as in income tax basis financial statements and some modified cash basis financial statements, annual depreciation expense should be allocated to interim periods.

Gains and Losses

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. However, depending on the basis of accounting used, if gains are deferred in year-end financial statements (e.g., installment sales for entities using the income tax basis of accounting), then best practices indicate that such gains should also be deferred in interim financial statements.

Interim Income Tax Provision

Generally, interim financial statements presented on the pure cash basis should report an income tax provision equal to disbursements for income taxes during the period. However, for interim statements presented on the modified cash basis or the income tax basis, best practices indicate that the tax provision should be computed following the guidance in FASB ASC 740-270 for interim GAAP statements. That generally would require calculating the interim tax provision by applying the estimated effective tax rate for the year to pretax income for the interim period. Effectively this allocates the tax provision that will be recognized in the annual financial statements to interim periods in the proportion income is recognized. If interim financial statements omit a tax provision when following the guidance in this paragraph would require measuring one, best practices indicate that the omission should be reported as a departure from the applicable financial reporting framework in the accountant's report.

Unusual or Infrequently Occurring Items and Disposal of a Component of an Entity

Material unusual or infrequently occurring 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.

Changes in Accounting Principles

FASB ASC 250-10-05-2 establishes the basic presumption that a change in accounting principle should be applied retrospectively. In financial statements that include the year with the change in comparison with prior years, the financial statements for the prior years should be revised to reflect results using the new accounting principle unless it is impracticable to determine the effect of the change for those periods. If it is impractical, the change should be applied as of beginning of the earliest year presented for which determining the adjustment is impracticable. If it is impracticable to determine the effect of the change at the beginning of any of the years presented, the change should be applied prospectively from the earliest date practical.

Those principles generally apply to presentations of financial results for interim periods, except that the notion of impracticability is applied differently. Under FASB ASC 250-10-05-3 and 250-10-45-14, if it is impracticable to apply the new accounting principle retrospectively to prior interim periods of the year in which management decides to change the accounting principle, the change cannot be made during that year. Instead, the change should be made as of the beginning of a subsequent year.

Best practices indicate that these principles should be applied to interim financial statements of the year of change prepared using the modified cash or income tax basis of accounting. To illustrate, assume that an entity prepares income tax basis financial statements quarterly and wants to change an accounting principle beginning in 20X1.

- a. If the entity makes that decision in the first quarter of 20X1 and issues financial statements for that quarter only, the results for the quarter should reflect the new accounting principle, and retained earnings at the beginning of 20X1 should be adjusted for the cumulative effect of the change.

- b. If the entity makes that decision in the third quarter of 20X1 and issues financial statements for that quarter and year-to-date, the financial results for both periods should reflect the new accounting principle.
- c. If the entity issues comparative financial statements showing financial results for each of the first three quarters, the results for each of the quarters should reflect the new accounting principle.
- d. If management believes it is not practicable to revise the financial results for the first two quarters, or for one of those quarters, the entity cannot make the change in 20X1.

But what if financial statements for the interim period of change are presented in comparison with the same interim period of the prior year? Best practices indicate that the answer differs depending on whether the financial statements are prepared using the modified cash basis or the income tax basis.

- a. *Modified Cash Basis.* If the modified cash basis of accounting is used, the guidance in FASB ASC 250-10 should be followed.
 - (1) If the entity believes it is practicable to revise the financial statements of the prior year, the financial statements for the prior-year interim period should be revised to reflect the new accounting principle.
 - (2) If the entity believes revising the financial statements of the prior year is impracticable but the effect at the beginning of the current year can be determined, the financial statements for the prior-year interim period should reflect the former accounting principle.
- b. *Income Tax Basis.* Since prior-year tax returns are not amended for a change in accounting principle, income tax basis financial statements for the prior-year interim period should reflect the former accounting principle.

DISCLOSURES IN INTERIM FINANCIAL STATEMENTS

For small and midsize entities, full-disclosure interim statements often are not necessary or cost-effective. Accordingly, best practices indicate that interim financial statements of entities using special purpose frameworks ordinarily are presented without disclosures. If disclosures are presented, AU-C 800.17 requires that 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. AU-C 800.17 is applicable to disclosures in interim financial statements. Accordingly, best practices indicate that the disclosures required in special purpose financial statement presentations should be evaluated by (a) identifying the disclosures that would be required for a GAAP presentation, (b) deciding whether those disclosures are relevant to the financial reporting framework used, and (c) deciding whether the relevant GAAP disclosure requirements should be followed or alternative ways to communicate the substance of those requirements should be explored.

Disclosure requirements for interim financial statements of nonpublic companies are basically the same as for annual financial statements. The following exceptions, however, may apply to interim financial statements that do not omit substantially all disclosures:

- a. FASB ASC 235-10-50-2 states that disclosure of accounting policies is not required for unaudited interim financial statements unless an accounting policy has been changed. Therefore, best practices indicate that such disclosure is also not required for special purpose interim financial statements. 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. 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

operating results 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, as well as significant adjustments to reconcile to the annual physical inventory. Any other unusual methods of accounting for interim inventories, such as LIFO estimations discussed earlier in this section, should also be disclosed.
- d. 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. These disclosures can generally be made on the face of the statement of revenues and expenses, by providing an appropriate descriptive title to the cost or expense shown as a single line item.
- e. If any accounting principle used in an interim financial statement differs from that applied in the preceding interim period, the prior annual financial statements, or the comparable interim period of the prior year, disclosure of the change is required in the interim financial statements.
- f. Disclosure should be made of any significant variations in the customary relationship between income tax expense and pretax income if the reasons the variations exist are not apparent.
- g. Disclosure should be made of any contingencies and other uncertainties when such disclosures are necessary to prevent the interim financial statements from being misleading.
- h. The effect of a change in accounting estimate should be disclosed if it is material to any interim period presented.

INTERIM REPORTING

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 under AR-C 70 are discussed in *PPC's Guide to SSARS Preparation Engagements*. 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.

Reporting When There Are Certain Differences between Interim and Annual Financial Statements

Use of Different Bases of Accounting at Interim and Annual Periods. The SSARS imply that a nonpublic entity is permitted to use a special purpose framework for preparing its interim financial statements and GAAP for preparing its annual statements. As long as the basis of accounting and the primary differences from GAAP are disclosed adequately 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 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.

Special Considerations for Twelfth-month Interim Statements When a Higher Level of Service Will Be Performed. Frequently, companies issue interim statements that omit substantially all disclosures and are 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? Best practices indicate that accountants who find themselves in that position stamp the twelfth-month statements "Draft" and follow up with final audited, reviewed, or compiled statements after the year-end work is complete. Submitting preliminary financial statement drafts is discussed in *PPC's Guide to Compilation and Review Engagements*.

Change in the Basis of Accounting

Lesson 2 addresses reporting when a company changes its basis of accounting (for example, from GAAP to income tax basis) from that used in a prior year. Best practices indicate that the same guidance applies when an entity changes the basis of accounting it uses from one interim period to the next. In summary, they believe that—

- a. for comparative purposes, any prior interim periods presented should be restated to the new basis of accounting adopted by the company.
- b. 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 disclosed adequately in interim financial statements that do not omit substantially all disclosures.)

Periods Covered in the Accountant's Report for Interim Financial Statements

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, 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 "statement of assets, liabilities, and equity—income tax basis of XYZ Company as of September 30, 20XX, and the related statements of revenues, expenses, and retained earnings—income tax basis *for the periods then ended (or for the periods specified)*." 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. Best practices indicate that such a report would not be misleading as long as the related statements of revenues, expenses, and retained earnings—income tax basis specify the periods covered in the financial statements' headings.

Providing Monthly Reports Containing Only Selected Financial or Operational Information

In some cases, clients need only selected or summarized financial or operational information, such as account balances or operating to make the decisions necessary to run their businesses. 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.

NONREPORTING OPTIONS FOR INTERIM FINANCIAL STATEMENTS

Prior to the issuance of SSARS No. 21, the SSARS allowed accountants to provide clients with management-use-only financial statements without issuing a compilation report if the statements were not reasonably expected to be used by third parties. SSARS no longer allow the use of management-use-only financial statements. However, they do allow a non-reporting option by following the guidance in AR-C 70.

Many clients will choose to engage the accountant to prepare the financial statements. Such financial statement preparation engagements must comply with the requirements of AR-C 70. Additional guidance on financial statement preparation engagements is included in *PPC's Guide to SSARS Preparation Engagements*. Depending on the needs of the client, some clients may choose to have the interim financial statements prepared, but engage the accountant to compile, review, or audit the annual financial statements. The year-end engagements would then be subject to the applicable professional standards.

SELF-STUDY QUIZ

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

22. Which of the following statements is correct regarding interim engagements?
- a. Compilation services are seldom provided for interim statements using a special purpose framework.
 - b. Accountants are not allowed to use a different framework when reviewing interim financial statements in accordance with AU-C 930.
 - c. SSARS are applicable to reviews of interim financial information if the entity's most recent financial statements have been audited by the accountant.
 - d. SSARS are not applicable to reviews of interim financial information if the entity prepares its interim financial information using a different financial reporting framework as that used to prepare its annual financial statements.
23. Which of the following statements is correct regarding revenues and expenses when preparing interim financial statements?
- a. Adjustments should be made to annualize seasonal revenue.
 - b. Companies should disclose the seasonal character of the company's business in financial statements that do not omit substantially all disclosures.
 - c. Revenue from services rendered or products sold should be recognized on the cash basis.
 - d. Accountants cannot allocate cost or expense items to those interim periods if a specific cost or expense item charged to expense for annual reporting purposes benefits multiple interim periods.
24. Best practices indicate that changes in accounting principles should be applied to interim financial statements of the year of change prepared using the modified cash or income tax basis of accounting. Entity A prepares income tax basis financial statements quarterly and wants to change an accounting principle beginning in 20X1. If Entity A makes the decision in the third quarter of 20X1 then issues financial statements for that quarter and year-to-date, which of the following will occur?
- a. The entity cannot make the change in 20X1.
 - b. Only the results for the third and fourth quarters should reflect the new accounting principle.
 - c. The financial results for both periods should reflect the new accounting principle.
 - d. The results for the quarter should reflect the new accounting principle, and retained earnings at the beginning of 20X1 should be adjusted for the cumulative effect of the change.

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.)**

22. Which of the following statements is correct regarding interim engagements? **(Page 65)**

- a. Compilation services are seldom provided for interim statements using a special purpose framework. [This answer is incorrect. It is believed that compilation and review services are the primary financial statement services provided for interim financial statements prepared using a special purpose framework.]
- b. Accountants are not allowed to use a different framework when reviewing interim financial statements in accordance with AU-C 930. [This answer is correct. SSARS imply that an accountant is permitted to prepare interim financial statements using a different framework than used to prepare year-end statements when performing the interim review. However, this is not allowed for accountants reviewing interim financial statements in accordance with AU-C 930.]**
- c. SSARS are applicable to reviews of interim financial information if the entity's most recent financial statements have been audited by the accountant. [This answer is incorrect. In accordance with AR-C 90.02, SSARS are not applicable to reviews of interim financial information if the entity's latest annual financial statements have been audited by the accountant or a predecessor. Other criteria must also be met for SSARS to be applicable to reviews of interim financial information.]
- d. SSARS are not applicable to reviews of interim financial information if the entity prepares its interim financial information using a different financial reporting framework as that used to prepare its annual financial statements. [This answer is incorrect. In accordance with AR-C 90.02, SSARS are not applicable to reviews of interim financial information if the entity prepares its interim financial information using the same financial reporting framework as that used to prepare its annual financial statements. Other criteria must also be met for SSARS to be applicable to reviews of interim financial information.]

23. Which of the following statements is correct regarding revenues and expenses when preparing interim financial statements? **(Page 65)**

- a. Adjustments should be made to annualize seasonal revenue. [This answer is incorrect. According to FASB, adjustments should not be made to annualize seasonal revenue.]
- b. Companies should disclose the seasonal character of the company's business in financial statements that do not omit substantially all disclosures. [This answer is correct. In financial statements that do not omit substantially all disclosures, companies should disclose the seasonal nature of the company's business.]**
- c. Revenue from services rendered or products sold should be recognized on the cash basis. [This answer is incorrect. Revenue from products sold or services rendered should be recognized on the same basis as followed for the full year.]
- d. Accountants cannot allocate cost or expense items to those interim periods if a specific cost or expense item charged to expense for annual reporting purposes benefits multiple interim periods. [This answer is incorrect. When a specific cost or expense item charged to expense for annual reporting purposes benefits more than one interim period, best practices suggest following the general guidance in FASB ASC 270-10-45-4 for interim GAAP financial statements, the cost or expense item may be allocated to those interim periods.]

24. Best practices indicate that changes in accounting principles should be applied to interim financial statements of the year of change prepared using the modified cash or income tax basis of accounting. Entity A prepares income tax basis financial statements quarterly and wants to change an accounting principle beginning in 20X1. If Entity A makes the decision in the third quarter of 20X1 then issues financial statements for that quarter and year-to-date, which of the following will occur? **(Page 67)**
- a. The entity cannot make the change in 20X1. [This answer is incorrect. If management believes it is not practicable to revise the financial results for the first two quarters, or for one of those quarters, the entity cannot make the change in 20X1.]
 - b. Only the results for the third and fourth quarters should reflect the new accounting principle. [This answer is incorrect. If the entity issues comparative financial statements showing financial results for each of the first three quarters, the results for each of the quarters should reflect the new accounting principle.]
 - c. **The financial results for both periods should reflect the new accounting principle. [This answer is correct. If the entity makes that decision in the third quarter of 20X1 and issues financial statements for that quarter and year-to-date, the financial results for both periods should reflect the new accounting principle.]**
 - d. The results for the quarter should reflect the new accounting principle, and retained earnings at the beginning of 20X1 should be adjusted for the cumulative effect of the change. [This answer is incorrect. If the entity makes that decision in the first quarter of 20X1 and issues financial statements for that quarter only, the results for the quarter should reflect the new accounting principle, and retained earnings at the beginning of 20X1 should be adjusted for the cumulative effect of the change.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting— Course 1—Other Bases of Accounting, Reporting on Special Purpose Framework Financial Statements, and Interim Engagements (OFSTG171)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and 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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PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below (\$89 for email or fax; \$99 for regular mail). The answer sheets are found at the end of the course PDFs. Answer sheets may be printed from the PDFs; 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**
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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. Each answer sheet sent for print grading 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

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EXAMINATION FOR CPE CREDIT**Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting—Course 1—Other Bases of Accounting, Reporting on Special Purpose Framework Financial Statements, and Interim Engagements (OFSTG171)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. Which of the following is **not** an example of the contractual basis of accounting?
 - a. Joshua's company presents assets at amounts expected to be realized in liquidation and liabilities at amounts expected to be paid to creditors.
 - b. Elizabeth offers to buy the equity interests of Entity B. This offer may require a statement of financial position prepared using tax positions Entity B currently uses and tax positions that Elizabeth is considering if she acquires Entity B.
 - c. Foundations Inc., a personal service corporation, has a buy-out agreement with its majority stockholder that requires a statement of financial position prepared using the cash basis Foundations Inc. uses for tax reporting modified to recognize all receivables that are less than 90-days old and to recognize work-in-process that is likely to be realized.
 - d. Melodi signs an agreement to purchase the equity interest of the founder of Entity C which requires the entity to provide annual financial statements prepared using GAAP except that Entity C's real estate is to be measured at its fair value and its inventory is to be measured at replacement cost instead of LIFO.
2. Which of the following uses GAAP accounting guidance as opposed to regulatory accounting practices (RAP)?
 - a. Banks and savings institutions.
 - b. Banks and savings institutions with less than \$10 million in assets.
 - c. Credit unions with less than \$10 million in assets.
 - d. Do not select this answer choice.
3. Ben is engaged to audit Entity Z. During his audit, Ben uses a definite set of logical and reasonable criteria that is applied to all material items included in Entity Z's financial statements. According to AU-C 800.07, which of the following financial reporting framework other than GAAP is Ben using?
 - a. Regulatory.
 - b. Other.
 - c. Contractual.
 - d. Liquidation.

4. The FASB has been carefully progressing toward providing guidance on a comprehensive application of fair values. Which of the following has the FASB **not** made a determination on?
- a. Disclosure of financial instruments' fair values.
 - b. Definite set of criteria on fair value measurements.
 - c. Expanded fair value measurement guidance required by current GAAP.
 - d. Option of electing to measure specific financial instruments at their fair value.
5. Which of the following statements regarding the liquidation basis is correct?
- a. For entities for which liquidation is imminent, the liquidation basis is GAAP.
 - b. Hypothetical assumptions must be developed when liquidation is imminent.
 - c. Most small to midsize nonpublic entities for which liquidation is not imminent are still likely to find liquidation basis financial statements useful.
 - d. FASB ASC 274-10 provides guidance for when the use of the liquidation basis is considered to be GAAP.
6. Which of the following should be included in the introductory paragraph of a review report?
- a. A statement that a review is higher in scope than an audit.
 - b. The identity of the entity whose financial statements have been reviewed.
 - c. A listing of management's responsibilities for the financial statements.
 - d. The city and state where the accountant practices.
7. Woody, a CPA, is not independent with respect to Quest Outdoor Apparel (QOA). What type(s) of report, if any is Woody allowed to issue on QOA's financial statements?
- a. Woody may issue a compilation report, but not a review report, if he discloses his lack of independence.
 - b. Woody is precluded from issuing any report on QOA's financial statements due to his lack of independence.
 - c. Woody may issue a review report, but not a compilation report, if he discloses his lack of independence.
 - d. Woody may issue either a compilation or review report under AR-C 80.23.
8. When making a decision regarding independence, an accountant should follow which of the following?
- a. SSARS.
 - b. GAAP.
 - c. AICPA Technical Practice Aid.
 - d. AICPA *Code of Professional Conduct*.

9. 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 would include which of the following?
- Paragraph concerning the basis of accounting.
 - Summary of significant accounting policies.
 - Description of how the special purpose framework differs from GAAP.
 - Note describing the framework.
10. Larry, an accountant, has become aware of material measurement departures from the applicable financial reporting framework while performing a review engagement of Quicksand Construction. Larry has three possible courses of action. Which of the following is the preferred course of action?
- Refer to the departure in the review report.
 - Withdraw from the engagement with Quicksand Construction.
 - Encourage Quicksand Construction to revise the statements to conform to the applicable financial reporting framework.
 - Issue a qualified opinion.
11. According to the definition, an emphasis-of-matter paragraph should do which of the following?
- Only focus on a matter already presented or disclosed in the financial statements.
 - Explain procedures that the accountant has performed.
 - Include the term *substantial doubt*.
 - Contain the accountant's opinion.
12. The accountant is required to include an emphasis-of-matter or other-matter paragraphs in the accountant's report relating to specific matters. Which of the following is **not** one of those situations?
- The accountant's report contains going concern matters.
 - When the auditor's report on prior period financials statements is not reissued and the prior-period financial statements were audited.
 - The accountant's report includes required supplementary information.
 - When the financial statements are prepared in accordance with a special purpose framework are included in the accountant's report.
13. Which of the following specifies the language accountants should use in restricted use reports?
- AR-C 70.01.
 - AR-C 80.23.
 - AR-C 90.61–.62.
 - AU-C 570.

14. Which of the following scenarios is appropriate for restricted-use compilation or review reports?
- a. An accountant is permitted to restrict the use of a report even if not required to do so by professional standards.
 - b. The accountant will be responsible for controlling the distribution of any restricted-use reports he or she issues.
 - c. As long as the report indicates that it is not intended for general use, the specified parties do not need to be identified in the report.
 - d. Once the financial statements have been restricted and the engagement completed, other specified parties cannot be added.
15. Generally, where should the Other-Matter paragraph be located in the auditor's report?
- a. Before the opinion paragraph.
 - b. Immediately following the management's responsibility for the financial statements.
 - c. Immediately following the opinion paragraph.
 - d. At the end of the report.
16. How should the auditor modify the standard report if there is a disclosure departure from the special-purpose framework?
- a. Qualified opinion.
 - b. Adverse opinion.
 - c. Disclaimer of opinion.
 - d. Other-matter paragraph.
17. How should the auditor modify the standard report if there is a pervasive departure from the special-purpose framework?
- a. Qualified opinion.
 - b. Adverse opinion.
 - c. Disclaimer of opinion.
 - d. Other-matter paragraph.
18. Which of the following sources of authoritative guidance should auditors refer to when departures from the applicable financial reporting framework are material?
- a. AU-C 705.
 - b. AU-C 708.
 - c. AU-C 570.
 - d. AU-C 600.

19. Russell is performing a review engagement for Feed & Seed. The client had a change in accounting principle that materially affects the comparability of the financial statements. How should Russell modify his report?
- Russell must qualify his opinion.
 - Russell must issue an adverse opinion.
 - Russell doesn't need to modify his report.
 - Russell should include an emphasis-of-matter paragraph.
20. If an auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, the auditor is required to evaluate disclosures. If such disclosures are adequate, what should the auditor do?
- Express an unmodified opinion and add an emphasis-of-matter paragraph.
 - Express a qualified opinion.
 - Express an adverse opinion.
 - Repeat the emphasis-of-matter paragraph even if substantial doubt has been removed the next year.
21. Alexa is engaged to audit Libby's Gourmet Cupcakes. During her audit she expressed an opinion on prior-period financial statements that were different from her previous opinion. Alexa updated the report and disclosed all of the substantive reasons for the change in the opinion. How should this disclosure be made?
- Explanatory paragraph.
 - Other-matter paragraph.
 - Qualified opinion.
 - Introductory paragraph.
22. According to AICPA Technical Q&A 8800.02, when there is more than one component auditor, the group auditor's decision to make reference is made independently for each component auditor. The group auditor *typically* should modify which of the following when making reference to the work of a component auditor?
- Other Reporting Responsibilities.
 - Management's Responsibility for the Financial Statements.
 - Auditor's Responsibility section and the Opinion paragraph of the standard report.
 - Introductory paragraph.
23. Auditors can report on regulatory basis financial statements on which of the following if the statements and report are intended to be solely used by parties within the entity and by one or more regulatory agencies?
- Contractual basis.
 - Statutory.
 - Personal.
 - Special purpose framework.

24. Harold, an auditor is engaged to audit the financial statements of ABC Pharmaceuticals. During his audit, Harold discloses the financial effect of the subject matter on ABC's financial position, results of operations, and cash flows in a basis for modification of his report, immediately preceding the opinion paragraph. What type of opinion is Harold issuing?
- a. Qualified.
 - b. Adverse.
 - c. Disclaimer.
 - d. Unqualified.
25. Which of the following statements regarding considerations for compilations and reviews is correct?
- a. According to the SSARS definition of financial statements, financial presentations included in tax returns would not be considered financial statements.
 - b. Accountants are precluded from issuing a review report on financial information from a tax return.
 - c. For SSARS purposes, Form 5500 is not considered a tax return.
 - d. Do not select this answer choice.
26. A review of contractual basis financial statements should be done according to which of the following?
- a. AR-C 80.
 - b. Special purpose framework.
 - c. GAAP.
 - d. GAAS.
27. A compilation of contractual basis financial statements should be performed in accordance with which of the following?
- a. Special purpose framework.
 - b. AR-C 80.
 - c. AR-C 90.
 - d. GAAP.
28. Which of the following provides guidance on compiling or preparing financial statements based on a prescribed form?
- a. GAAP.
 - b. AICPA Guide.
 - c. AU-C 570.
 - d. SSARS.

29. Which type of engagement is generally not appropriate for financial statements included in a prescribed form because the resulting report does **not** address financial statements that omit substantially all disclosures?
- a. Audit.
 - b. Compilation.
 - c. Preparation.
 - d. Review.
30. Best practices suggest that audited personal financial statements be reported on in the same manner as financial statements prepared following the guidance in AU-C 800 when using which of the following bases?
- a. Cash.
 - b. Modified cash.
 - c. Historical cost.
 - d. Income tax.
31. Compilations and reviews of personal financial statements prepared on a comprehensive basis other than GAAP are subject to which of the following SSARS requirements?
- a. Performance.
 - b. Reporting.
 - c. Performance and reporting.
 - d. Disclosure.
32. The form and substance of a compilation or review report issued in connection with personal financial statements prepared using a special purpose framework should not differ from such reports issued for commercial entities. Nevertheless, subtle differences in wording are caused by the nature of the engagement. The example reports in the AICPA Guide state all of the following **except**:
- a. Identify the individuals about whom the financial statements are prepared.
 - b. In a review, note that the inquiries were not made of management, but of individuals.
 - c. Note that the representations are those of individuals rather than company management.
 - d. Identify the company about whom the financial statements are prepared.
33. Which of the following allows accountants to issue a compilation report on financial statements that omit substantially all disclosures?
- a. FASB ASC 820.
 - b. AR-C 70.01.
 - c. AU-C 725.
 - d. AR-C 80.27.

34. According to which of the following can an accountant audit a specified element of a financial statement that is separately presented?
- a. GAAP.
 - b. AU-C 725.
 - c. AR-C 80.17.
 - d. AU-C 805.
35. Which of the following methods is used for estimating inventories and cost of goods sold at interim dates when physical inventories are not taken?
- a. LIFO.
 - b. Gross profit.
 - c. Specific identification.
 - d. FIFO.
36. Clint is preparing interim financial statements using a special purpose framework. Which of the following is a correct method for recognizing and measuring transactions?
- a. Annual depreciation expenses should be allocated to interim periods if recognized.
 - b. Adjustments should be made to annualize seasonal revenue.
 - c. For LIFO inventory values, a precise interim calculation is required.
 - d. The gross profit method is not an acceptable inventory method for interim GAAP statements.
37. In general, interim financial statements presented on which of the following bases should report an income tax provision equal to disbursements for income taxes during the period?
- a. Modified cash.
 - b. Pure cash.
 - c. Income tax.
 - d. Regulatory.
38. FASB ASC 250-10-05-2 establishes the basic assumption that a change in accounting principle should be applied retrospectively. Which of the following will occur if financial statements include the year with the change in comparison with prior years?
- a. The financial statements for the prior years should be revised to reflect results using the new accounting principle unless it is impracticable to determine the effect of the change for those periods.
 - b. The change should be applied as of the beginning of the earliest year presented.
 - c. The change should be applied prospectively from the earliest date practical.
 - d. The change cannot be made during that year.

39. Which of the following statements is correct regarding disclosures in interim financial statements?
- a. FASB ASC 250-10-05-2 requires full-disclosure interim statements for small and midsize entities.
 - b. Entities using special purpose frameworks generally present their interim financial statements without disclosures.
 - c. FASB ASC 270 is applicable to disclosures in interim financial statements.
 - d. The disclosures required in special purpose financial statement presentations are the same as GAAP.
40. Which of the following statements is correct regarding disclosures in interim financial statements of nonpublic companies?
- a. Accountants are only required to disclose accounting policies for unaudited interim financial statements when an accounting policy has been changed.
 - b. If a company has seasonal variations, the seasonal nature of their activities should be disclosed, and consideration should be given to supplementing interim reports with information for a 6-month period ending with the interim date.
 - c. Disclosure of the change is not required in the interim financial statements if accounting principles used in interim financial statements are different from those applied in the prior annual financial statements, the preceding interim period, or the comparable interim period of the prior year.
 - d. Accountants are not required to disclose the nature and amount of material costs or expenses incurred in an interim period that cannot be readily identified with the benefits or activities of other interim periods.

GLOSSARY

Adverse opinion: An overall audit opinion that states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (also known as a special purpose framework). Auditors must have as much sufficient evidential matter to support an adverse opinion as for an unqualified opinion.

Cash basis: Using the *pure* cash basis, the only asset reflected on the financial statement is cash, no liabilities, and only cash receipts and disbursements are reported as increases and decreases in net assets.

Compilation: Presenting, in the form of financial statements, information that is the representation of management (owners) without undertaking to express any assurance on the statements.

Contractual basis: A basis of accounting that is required by a contract or other agreement and does not comply with GAAP, the cash basis, the tax basis, or the regulatory basis.

Disclaimer of opinion: An expression of no opinion. The auditor does not express an opinion on the financial statements due to lack of independence or pervasive and massive deficiency of evidence or uncertainty.

Disclosure: Description of pertinent facts in a financial report.

Fair value basis: Using the definition in FASB ASC 820-10-20, *fair value* is “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.”

Gross profit method: The gross profit method, commonly used for estimating inventories and cost of goods sold at interim dates when physical inventories are not taken, is an acceptable method for use in interim GAAP financial statements under FASB ASC 270-10-45-6.

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.

Historical cost basis personal financial statements: Personal financial statements presented in accordance with GAAP measure assets and liabilities at their estimated current values and amounts, rather than at their historical costs.

Income tax basis of accounting: The basis of accounting an entity uses or expects to use to file its income tax return. The income tax basis of accounting is an other comprehensive basis of accounting. Typically, it is based on federal income tax laws found in the Internal Revenue Code and related revenue rulings, regulations, and procedures.

Intangible assets: Nonphysical assets (lacking physical substance) whose value derives from the rights that their ownership confers (e.g., goodwill). The evidence of existence of an intangible asset is elusive, value is often difficult to estimate, and useful life is often indeterminable.

Liquidation basis: The liquidation basis of accounting presents assets at amounts expected to be realized in liquidation and liabilities at amounts expected to be paid to creditors.

NAIC codification: The National Association of Insurance Commissioners codified statutory accounting principles for certain insurance enterprises, in a *NAIC Accounting Practices and Procedures Manual* (the Manual).

Other basis: A basis of accounting that utilizes a definite set of logical and reasonable criteria that is applied to all material items included in the financial statements.

Other information: Financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding required supplementary information.

Qualified opinion: The auditor should express a qualified opinion when the auditor concludes that misstatements, individually or in the aggregate, are material but not pervasive to the financial statements, or the auditor is unable

to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Review: An engagement undertaken to achieve, through the performance of inquiry and analytical procedures, limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with GAAP or, if applicable, with an other comprehensive basis of accounting. The accountant on a review engagement must show due professional care and is required to be independent.

Supplementary information: Information presented outside the basic financial statements, excluding required supplementary information that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework.

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COMPANION TO PPC'S GUIDE TO CASH, TAX, AND OTHER BASES OF ACCOUNTING

COURSE 2

FORM AND STYLE CONSIDERATIONS AND DISCLOSURES IN SPECIAL PURPOSE FRAMEWORK PRESENTATIONS (OFSTG172)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course takes a look at two topics that affect financial statements that use special purpose frameworks. Lesson 1 discusses form and style considerations that apply to these types of financial statements. Lesson 2 covers making disclosures in special purpose financial statement presentations.

PUBLICATION/REVISION DATE: November 2017

RECOMMENDED FOR: Users of *PPC's Guide to Cash, Tax, and Other Bases of Accounting*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of accounting

CPE CREDIT: 8 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 **November 30, 2018**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Form and Style Considerations

Completion of this lesson will enable you to:

- Identify form and style considerations for financial statements presented using special purpose frameworks related to the title page, the table of contents, presentation of the accountant's or auditor's report, and the basic financial statements.
- Recognize appropriate form and style for financial statement notes, supplementary or other information, and other miscellaneous elements of financial statements presented using special purpose frameworks.

Lesson 2—Disclosures in Special Purpose Framework Presentations

Completion of this lesson will enable you to:

- Recognize the presentation requirements for disclosures in special purpose framework presentations, as well as special considerations related to cash flows information, the summary of significant accounting policies, financial statement items for which GAAP requires disclosure, and other information that GAAP would require disclosing.

- Identify the disclosure methods financial statements prepared using a special purpose framework should use for changes in financial reporting frameworks, the omission of substantially all disclosures, and the consolidation of variable interest entities.
- Determine the best way for financial statements prepared using a special purpose framework to disclose accounting for uncertainty in income taxes and how such financial statements should deal with other considerations, like fair value and noncontrolling financial interest.

TO COMPLETE THIS LEARNING PROCESS:

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ADMINISTRATIVE POLICIES:

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Lesson 1: Form and Style Considerations

INTRODUCTION

Generally, authoritative literature does not require accountants to follow a specific format or style when preparing financial statements. The lack of guidance has resulted in a wide variety of financial statement styles, not only between CPA firms but within individual firms, as well. Such inconsistencies often lead to frustration when training new administrative staff and staff accountants.

This lesson is designed to add consistency to a preparer's financial statements and may be used as a convenient reference source when questions about financial statement style and form arise. The policies presented are logical, consistent, comprehensive, and easy to understand, and will result in a pleasing style. However, that *unless specifically stated otherwise, all of the policies in this lesson are suggestions made by this course. Use of the word "should" is not intended to imply that other policies are incorrect or inferior.*

Learning Objectives:

Completion of this lesson will enable you to:

- Identify form and style considerations for financial statements presented using special purpose frameworks related to the title page, the table of contents, presentation of the accountant's or auditor's report, and the basic financial statements.
- Recognize appropriate form and style for financial statement notes, supplementary or other information, and other miscellaneous elements of financial statements presented using special purpose frameworks.

Financial Reports

The term "Financial Report" is used throughout this course to refer to the entire package that typically incorporates the financial statements. For special purpose framework presentations, the package generally includes many, if not all, of the following:

- Title (or cover) page
- Table of contents
- Accountant's or auditor's report
- Basic financial statements and notes
- Other financial or supplementary information

The following sections discuss style considerations relative to each of the major components of a typical special purpose framework Financial Report.

THE TITLE PAGE (COVER PAGE)

General

It is a best practice to include a title page in all financial statement presentations. The title page should contain the name of the company, the title of the financial statements, the special purpose framework used to prepare the financial statements, and the date or period covered as follows:

XYZ CORPORATION
FINANCIAL STATEMENTS—INCOME TAX BASIS
Years Ended December 31, 20X2 and 20X1

Note that all lines are centered and that a line is skipped between each line of the title. The name of the company and the term “Financial Statements—Income Tax Basis” are capitalized whereas only the first letter of each word in the date or period covered by the financial statements is capitalized.

If the preparer uses a front cover that has a window, the preceding information should be on the first page, and positioned to appear through the cover's window. If the cover has no window, the information should be typed or printed on the cover and located above center since that is the section that first draws the reader's attention.

The cover information should appear only once. Accordingly, if a cover without a window is used, the information should be typed or printed on the cover, and the next page should be the table of contents.

Name of the Entity

The name of the entity should be presented exactly as listed in its charter, or appropriate legal document. In addition, the legal form of the entity, for example, trust, estate, nonprofit organization, or S corporation, should be disclosed if it is not apparent from the entity's name. This course suggests disclosing the type of entity in the accounting policies note, although many accountants disclose it on the title page or parenthetically in the accountant's or auditor's report. Examples of appropriate presentations of the names of the entity on the title page are as follows:

- ABC CORPORATION
- THE ESTATE OF JOHN DOE
- MR. AND MRS. JOHN Q. PUBLIC
- JANE DOE TESTAMENTARY TRUST

Statement Titles

If the presentation includes more than one type of financial statement, for example, Statement of Assets, Liabilities, and Equity—Income Tax Basis, Statement of Revenues, Expenses, and Retained Earnings—Income Tax Basis, and Statement of Cash Flows—Income Tax Basis, using the term “Financial Statements” on the title page is the most practical method of communicating to the reader what is included in the presentation. When only one type of statement is presented, however, it may be more appropriate to use the exact title of the statement on the title page. A discussion on the appropriate titles for financial statements included in a special purpose framework presentation appears later in this lesson.

Some practitioners add a description of the service performed to the title of the financial statements on the title page. For example—

XYZ CORPORATION

COMPILED FINANCIAL STATEMENTS—INCOME TAX BASIS

Years Ended December 31, 20X2 and 20X1

This course does not recommend that practice because it complicates the production process, especially when comparative statements with different levels of service are presented or when supplementary information is included and accountants are expressing a level of assurance on the supplementary information that differs from the assurance expressed on the financial statements. One exception to that policy is when comparative statements are presented and one period is audited and the other is unaudited as discussed in the following paragraph.

Different Levels of Service—Comparative Financial Statements

When audited financial statements are presented in comparative form with unaudited financial statements, it is a best practice to indicate the level of service (e.g., audited, unaudited, compiled, reviewed) on the title page. For example—

XYZ CORPORATION

FINANCIAL STATEMENTS—INCOME TAX BASIS

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

or

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

Consolidated or Combined Financial Statements

When consolidated or combined financial statements are presented, the title on the cover page should include the words “consolidated” or “combined.” For example—

- CONSOLIDATED FINANCIAL STATEMENTS—INCOME TAX BASIS
- COMBINED STATEMENTS OF ASSETS, LIABILITIES, AND EQUITY—CASH BASIS
- CONSOLIDATED STATEMENT OF REVENUES, EXPENSES, AND RETAINED EARNINGS—INCOME TAX BASIS

Date or Period Covered

When both a statement of assets, liabilities, and equity and a statement of revenues and expenses are presented, the title page should only reflect the period covered by the statement (or statements) of revenues and expenses as illustrated by the following:

- Years Ended December 31, 20X2 and 20X1
- Three Months Ended March 31, 20X2 and 20X1
- Six Months Ended June 30, 20X1
- One Month and Six Months Ended June 30, 20X1
- Years Ended December 27, 20X2 (52 weeks) and January 3, 20X1 (53 weeks)
- Year (52 weeks) Ended January 2, 20X1
- Quarters (13 weeks) Ended March 29, 20X2 and March 27, 20X1
- From January 23, 20X1 (Date of Inception) to March 31, 20X1
- From January 1, 20X1 to September 17, 20X1 (Date of Liquidation)

When only statements of assets, liabilities, and equity are presented, the date of the statements would appear on the title page as follows:

- December 31, 20X2 and 20X1

Annual Reports and Loan Proposals

Occasionally, the title "Financial Statements" does not adequately represent the contents of the package and, thus, should not be used on the cover or title page. When financial statements are bound with nonfinancial data (prepared either by the accountant or the company), a title such as "Annual Report" may be more appropriate. As an example, an annual report that includes audited comparative financial statements for 20X2 and 20X1 and supplementary financial information could include a cover or title page as follows:

XYZ, INC.
ANNUAL REPORT
Year Ended December 31, 20X2

Notice that the period covered is 20X2, the annual report period, even though the report includes financial statements of several periods. Alternatively, the title and report period could be combined by using "20X2 Annual Report."

When pro forma (or prospective) financial statements and historical financial statements are bound together for a loan proposal, the cover or title page might appear as follows:

NEW CORPORATION, INC.
LOAN PROPOSAL
November 17, 20X1

Generally, the date that the loan proposal was completed would be used on the title page because both historical and prospective financial statements covering different periods may be presented.

THE TABLE OF CONTENTS

A table of contents may not be necessary in presentations that consist of only a single financial statement, the accompanying notes, and an accountant's report. However, in longer financial reports (for example, those that include several financial statements or supplementary information), a table of contents can be useful to the reader and should be included.

Format Policies

The table of contents should be simple and easy to follow; otherwise it does not accomplish its objective of making the financial report easier for the reader to use. The following format policies may help the table of contents reach that objective:

- a. *Heading.* Rather than present a complete heading on the contents page, the term "TABLE OF CONTENTS" or simply "CONTENTS" should be used. (Production of the table of contents is simpler when the heading is limited.) This course suggests presenting the heading in "all caps" beginning at the left margin.
- b. *Page Referencing.* The table of contents need only refer to the first page on which an item appears—not all pages covered by the item. In addition, the column heading "Page No." could be used to identify the page references.
- c. *Organization.* Listed items should be grouped under major sections for the accountant's (or auditor's) report, financial statements, and supplementary information. The major sections should appear in "all caps" while the titles of the financial statements and supplementary schedules listed under the appropriate major section should be presented in "initial caps," exactly as shown on the page headings of the statements. Lines should be skipped between and within each major section, and the title of each listed item should be indented two spaces from the left margin.

The following illustrates how the preceding policies would be applied when a single accountant's report covers both the financial statements and other financial information:

TABLE OF CONTENTS

	Page No.
ACCOUNTANT'S COMPILATION REPORT	1
FINANCIAL STATEMENTS	
Statements of Assets, Liabilities, and Equity—Income Tax Basis	2
Statements of Revenues, Expenses, and Retained Earnings— Income Tax Basis	3
Statements of Cash Flows—Income Tax Basis	4
Notes to Financial Statements	5
SUPPLEMENTARY INFORMATION	
Schedule of Selling and Administrative Expenses—Income Tax Basis	9

If separate accountant's reports are presented, the following would be an appropriate presentation:

TABLE OF CONTENTS

	Page No.
ACCOUNTANT'S COMPILATION REPORT ON FINANCIAL STATEMENTS	1
FINANCIAL STATEMENTS	
Statements of Assets, Liabilities, and Equity—Income Tax Basis	2
Statements of Revenues, Expenses, and Retained Earnings— Income Tax Basis	3
Statements of Cash Flows—Income Tax Basis	4
Notes to Financial Statements	5
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SUPPLEMENTARY INFORMATION	
Schedule of Selling and Administrative Expenses—Income Tax Basis	10

THE ACCOUNTANT'S OR AUDITOR'S REPORT

Accountants in Industry

Lack of independence precludes an accountant in industry (also known as a *member in business*, as opposed to a *member in public practice*) from including audit reports or review reports with financial statements they prepare for their employers. AR-C 80.01 notes that AR-C 80 is applicable when the accountant has been engaged to perform a compilation. That would not be the case for an accountant preparing financial statements for his or her employer. Thus, accountants in industry would never be in a position in which they would issue an accountant's or auditor's report.

Although accountants in industry do not issue accountant's or auditor's reports, they are required to follow a code of conduct as stipulated by the specific state board of accountancy under which they are licensed, and most state boards of accountancy integrate ethics requirements the same as, or similar to, the AICPA *Code of Professional Conduct* (the Code). Such codes of conduct require accountants, among other things, to perform their work with integrity and objectivity, professional competence, and due professional care, thus indicating that accountants in

industry need to do good work and not be associated with financial statements that they know to be improperly or inadequately prepared.

ET 2.300.03020 of the Code requires members in business to communicate (preferably in writing), the member's relationship with the entity when the member prepares or submits financial statements of the entity to third parties. Additionally, the member should not imply that he or she is independent of the entity. Other than the preference that the communication be in writing, there is no mention in the Code of how the communication should be made. Accordingly, the member has discretion in making the communication, and including a cover letter with the financial statements is one acceptable approach. Though not required, the member can state affirmatively that the financial statements are presented in conformity with the applicable financial reporting framework. In doing so, the member should comply with the *Accounting Principles Rule* at ET 2.320.001. The Code's definition of a *member in business* includes a member who is employed by, is under contract to, or volunteers for an entity. Further information about accountants in industry and their responsibilities can be found in Part 2 of the Code. It is a good idea for members in business to be knowledgeable about those requirements. The remainder of this discussion on presentation of the report relates exclusively to members in public practice.

Letterhead

Although there is no requirement to do so, it is a best practice for the accountant's or auditor's report to be presented on the firm's letterhead. The use of firm letterhead adds the formality that reflects the professional approach to association with financial statements. Some practitioners may use software packages that generate the appropriate report, which may be difficult to print on firm letterhead. In those situations, accountants may 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 or auditor's report indicates the city and state of the office issuing the report, the requirement to include that information is met.

Report Title

AU-C 700, *Forming an Opinion and Reporting on Financial Statements*, at AU-C 700.23, indicates that reports on audited financial statements should use a title that includes the word "independent." This course suggests using "INDEPENDENT AUDITOR'S REPORT" as the title of audit reports. 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." AR-C 80 does not require the inclusion of a title for a compilation report. However, nothing precludes an accountant from including a title in a compilation report, if so desired. The accountant may indicate that he or she is independent in the title, if a title is used.

A minor point, but of interest to some, is the placement of the apostrophe in *Accountant's* or *Auditor's*. Many practitioners have questioned whether to use singular or plural terminology when referring to themselves as they report on the 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

Audit reports should be addressed as appropriate in the circumstances of the engagement. While AR-C 80 does not contain such a requirement for compilation reports, AR-C 90.39b does have an addressee requirement for review reports. However, nothing precludes an accountant from including an addressee in a compilation report, if so desired. Generally, the accountant's or auditor's report should be addressed to the Board of Directors or Stockholders. For closely held companies, however, it may be appropriate to address the report to a specific individual. In any event, reports are not intended as letters. Thus, it generally seems inappropriate to include street

names and zip codes in the address or salutations such as “Dear Sirs” or “Gentlemen.” Examples of addresses that may be appropriate are as follows:

- To the Board of Directors
DEF Corporation
Philadelphia, Pennsylvania
- To the Stockholders
DEF Corporation
- Mr. and Mrs. John P. Doe
Los Angeles, California
- The Partners
XYZ Partnership
- To the Managing Partner
ABC Company
New York, New York
- Mr. George S. Clark, Executor
Estate of John P. Doe
Columbus, Ohio

The report on a C or S corporation's financial statements generally should be addressed to the company whose financial statements are being presented or to its board of directors or stockholders. The terms “shareholders” or “shareowners” may be substituted for “stockholders.” (Preferably, the term should be consistent with the company's articles of incorporation.) The report on a proprietorship's financial statements generally is addressed to the proprietor. The report on a partnership's financial statements generally is addressed to the partnership using the name authorized in the partnership agreement or to the partners (or to the managing or general partner). Likewise, the report on a limited liability company's financial statements generally is addressed to the members or the Board of Members. In a single member LLC, it may be appropriate to address the report to the proprietor/member. The report on a nonprofit organization's financial statements is usually addressed to the governing board (for example, the board of directors or trustees). The report could be addressed to the organization itself, if the client so desires. For many small entities, management of the company is the same individuals as the owners or partners, so the report may be addressed to management of the entity.

The city and state (but not the street address or post office box number) in which the entity is located also are commonly included in the report address. However, many firms omit the city and state, especially when the report is addressed to stockholders who are widely dispersed.

Signature

Compilation, review, and audit reports should be signed. 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. The signature placed on a compilation or a review report can be manual, printed, or digital. AU-C 700.39 states that the auditor's report should include the manual or printed signature of the auditor's firm.

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.

This course suggests that the signature be placed on a line approximately midway between the end of the report and the date. Because the addressee of the accountant's report is blocked on the left margin, the signature could

begin on the left margin to provide a balanced appearance. If firm letterhead is used, there is no need to also type the firm name below the signature.

Date of Report

The date of the report affects the responsibility assumed by the accountant or auditor. This lesson focuses on form and style; therefore, an in-depth discussion of choosing a date is outside of the course's scope. More information on that subject is available in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*.

Beginning the date at the left margin will provide a consistent block format.

Reference to Office Location

Compilation and Review Reports. 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. The SSARS do not have a requirement regarding the placement of the city and state on the report. The illustrative reports in the SSARS show the city and state at the left margin 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.

Audit Reports. AU-C 700.40 requires the auditor's report to identify the city and state of the office where the auditor practices. Often, the auditor's address is located below the signature. Alternatively, this requirement is met when the audit report is presented on the firm's letterhead containing the city and state where the auditor practices. However, an AICPA Technical Question and Answer at Q&A 9100.08 clarifies that the requirement is not met if there are multiple office locations identified in the firm's letterhead on which the report is issued. In the case, the auditor needs to indicate the city and state in the auditor's report to make it clear which location is issuing the report.

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

Many accountants have questioned whether to use the singular (*I*) or plural (*We*) when referring to themselves in the accountant's or auditor's report. The previous discussion regarding the placement of the apostrophe in *Accountant's* also provides guidance in determining a suitable pronoun to use. However, this course recommends that sole practitioners with no professional staff use the singular (*I*) when referring to themselves in the accountant's or auditor's report. Using the plural pronoun *we*, especially while expressing an audit opinion on financial statements, might imply that there are partners or shareholders in the firm.

THE BASIC FINANCIAL STATEMENTS

Basic Financial Statements for a Special Purpose Framework

In a special purpose framework presentation, the basic financial statements typically present financial position and results of operations as measured under the special purpose framework, descriptions of accounting policies, and notes to the financial statements. An exception to that exists for entities using the pure cash basis of accounting, however. Under the pure cash basis of accounting, a statement of assets, liabilities, and equity would be superfluous because the cash balance would be the only item that would appear, and a statement of changes in equity would be unnecessary because the cash basis does not recognize equity. Consequently, entities using the pure cash basis of accounting present a single statement titled "Statement of Cash Receipts and Disbursements."

Other Statements

Statement of Cash Flows. AU-C 800, Appendix B, *Fair Presentation and Adequate Disclosure* (AU-C 800.A34), indicates 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 cash flow statement is presented, the accountant would report on the statement as a basic financial statement. (Lesson 2 provides additional considerations related to the presentation of cash flow information in special purpose financial statements.)

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. AU-C 800.17 indicates 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. The SSARS provide identical guidance (AR-C 80.18, AR-C 80.A31, AR-C 90.40, and AR-C 90.A83). Accordingly, it is a best practice for special purpose financial statements that present both financial position and results of operations to disclose changes in the components of stockholders' equity. (See Lesson 2 for additional guidance determining appropriate disclosures in special purpose financial statements.)

Most companies disclose the changes in a statement of stockholders' equity. The primary advantage of presenting the changes in one statement is that it allows readers to more easily understand the interrelationship of the accounts and the changes in them. In practice, accountants use either of the following formats for the statement of changes in stockholders' equity:

- *Account Format.* The accounts that comprise stockholders' equity are listed across the top of the statement and changes in each account are presented in columnar form and explained by captions to the left of the columns.
- *Report Format.* Individual statements for each stockholders' equity account are used to present the changes.

Presenting all changes in stockholders' equity in one statement is not the only method used in practice. Changes for each element of stockholders' equity may be disclosed in separate statements, on the face of the statement of assets, liabilities, and equity (however, that may be cumbersome, especially if there are numerous, complex changes), in notes to the financial statements, or in any combination of those formats. For example, changes in retained earnings might be disclosed in a separate statement or in combination with the statement of revenues and expenses, while changes in other equity accounts are presented in schedules or narrative form in the notes.

Statement of Retained Earnings. Under GAAP, changes in retained earnings are required to be disclosed whenever results of operations are presented. Based on AU-C 800.17 and .A19, as well as the SSARS (AR-C 80.18, AR-C 80.A31, AR-C 90.40, and AR-C 90.A83), it seems logical that special purpose financial statements should 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 software-generated 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 the 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 "Statement of Revenues, Expenses, and Retained Earnings—(Cash, Income Tax, or Other) 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.*

Statement of Changes in Partners' and Proprietor's Capital. It is a best practice for partnerships and sole proprietorships to also disclose changes in partners' or proprietor's capital whenever special purpose financial statements present both financial position and results of operations. The most common presentation for partnerships and sole proprietorships seems to be reporting the changes in capital on a statement of revenues, expenses, and partners' (or proprietor's) capital. However, it is not the only method used in practice. Changes for the elements of capital may be disclosed in one statement, separate statements, on the face of the statement of assets, liabilities, and equity, in notes to the financial statements, or in any combination of those formats.

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 any 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, it seems logical that reporting comprehensive income would not be 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 do not seem to occur regularly 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 includes a statement of cash flows, the requirement to disclose comprehensive income likely will not apply. Thus, further information regarding presenting comprehensive income in a set of special purpose financial statements is not provided in this course.

Statement Titles

AU-C 800.15 and .A17, as well as AR-C 80.A28 and AR-C 90.A81, indicate that titles of special purpose financial statements should differ from those for similar statements prepared in accordance with GAAP so that there is no implication that the statements are presented in conformity with GAAP. Financial statement titles used in the compilation, review, or audit report should reflect the titles used within the body of the financial statements. If the financial statements are not suitably titled, this is a departure from the financial reporting framework. While the authoritative guidance does not require specific titles, the following examples are 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—Income Tax Basis
- Statement of Revenue Collected and Expenses Paid
- Statement of Revenue and Expenses—Income Tax Basis

- Statement of Operations—Income Tax Basis
- Statement of Income—Statutory Basis

AICPA Technical Question and Answer (Q&A 1500.04), *Terminology for Special Purpose Financial Statements*, refers to the AU-C 800 guidance mentioned in the previous paragraph, and further indicates that the use of unmodified GAAP titles in financial statements prepared in accordance with a special purpose framework is not acceptable. However, the Q&A allows the use of the terms “Balance Sheet” and “Statement of Operations” provided the titles make clear that the financial statements are not presented in accordance with GAAP. AR-C 80.A28 and AR-C 90.A81 include similar guidance about financial statement titles of compiled and reviewed financial statements.

Chapter 3 of the AICPA Practice Aid, *Accounting and Financial Reporting Guidelines for Cash- and Tax-Basis Financial Statements* (the AICPA Practice Aid), also provides nonauthoritative guidance on appropriate financial statement title terminology for cash and tax basis presentations. Much of the discussion in the AICPA Practice Aid is similar to the information above, including a listing of how such financial statements may be titled. The discussion also indicates that cash and tax basis financial statement titles can be modified by simply adding “cash basis,” “modified cash basis,” or “tax basis,” after the financial statement title.

Special purpose statements can be easier to understand when consistent, uniform statement titles are used. Thus, this course recommends—

- using the title “Cash Basis” to refer to “Modified Cash Basis” financial statements (since the “modified cash basis” is frequently referred to as “cash basis” in practice), and
- using consistent titles (e.g., “Statement of Assets, Liabilities, and Equity” in referring to the balance sheet) for cash basis and tax basis financial statements, except for the addition of “cash basis” or “income tax basis” to the end of each title. This course suggests adding “income tax basis,” but the use of either “income tax basis” or “tax basis” would be appropriate. Whichever identifier is chosen, it should be used consistently.

This approach facilitates review and promotes consistency. Exhibit 1-1 summarizes this course’s recommendations for special purpose financial statement titles.

Exhibit 1-1

Recommended Special Purpose Financial Statement Titles

GAAP	Cash	Tax
1. Balance Sheet	1. Statement of Assets, Liabilities, and Equity (Capital)—Cash Basis	1. Statement of Assets, Liabilities, and Equity (Capital)—Income Tax Basis
2. Statement of Income	2. Statement of Revenues and Expenses—Cash Basis	2. Statement of Revenues and Expenses—Income Tax Basis
3. Statement of Income and Retained Earnings	3. Statement of Revenues, Expenses, and Retained Earnings (or Partners’ Capital, Proprietor’s Capital)—Cash Basis	3. Statement of Revenues, Expenses, and Retained Earnings (or Partners’ Capital, Proprietor’s Capital)—Income Tax Basis
4. Statement of Retained Earnings	4. Statement of Retained Earnings—Cash Basis	4. Statement of Retained Earnings—Income Tax Basis

GAAP	Cash	Tax
5. Statement of Changes in Stockholders' Equity	5. Statement of Changes in Stockholders' Equity (or Partners' Capital, Proprietor's Capital)—Cash Basis	5. Statement of Changes in Stockholders' Equity (or Partners' Capital, Proprietor's Capital)—Income Tax Basis
6. Statement of Cash Flows	6. Statement of Cash Flows—Cash Basis	6. Statement of Cash Flows—Income Tax Basis

Notes:

1. These statement titles are recommended by this course. They seem acceptable under AU-C 800 and the SSARS. Other equally suitable titles may be derived from the suggested titles.
2. These statement titles may not be appropriate for certain governmental or nonprofit organizations. See relevant AICPA Audit and Accounting Guides.
3. The pure cash basis has a single asset and no liabilities. Accordingly, there is no need to present a "Statement of Assets, Liabilities, and Equity." Instead, a single statement titled "Statement of Cash Receipts and Disbursements" is customarily presented.
4. Although a statement of cash flows for special purpose financial statements is not required, if it is presented, it is a best practice to title it "Statement of Cash Flows—Cash (or Income Tax) Basis."

* * *

Accounting software packages are used by many accountants to prepare financial statements. If the software package has predefined statement titles, they are usually GAAP titles, i.e., balance sheet, statement of income. Such GAAP titles should be modified to indicate the applicable special purpose framework.

Heading Financial Statements

Each financial statement should use a heading that includes the legal name of the entity, the title of the specific statement, the basis of accounting on which the financial statements have been prepared, and the date or period covered. Format such as the placement of the heading and capitalization should be consistent with the style used for other parts of the financial report. One method that is commonly used in business writing is called block style. In this style, the heading would begin at the left margin with the name of the entity and the statement title in "all caps" and the date or period covered in "initial caps." For example—

XYZ CORPORATION
STATEMENT OF ASSETS, LIABILITIES, AND EQUITY—INCOME TAX BASIS
March 31, 20X1

or

XYZ CORPORATION
STATEMENTS OF REVENUES, EXPENSES, AND RETAINED EARNINGS—INCOME TAX BASIS
Years Ended December 31, 20X2 and 20X1

The spacing between the last line of the financial statement heading and the first line of the column headings, e.g., 20X1, or the first caption in single-period financial statements, e.g., ASSETS, will vary with the length of the statement.

Different Levels of Service

When comparative financial statements are issued, the level of service provided for the periods presented may differ. Unaudited financial statements presented in comparative form with audited financial statements should be

clearly marked to indicate their status, which may be done parenthetically either in the statement headings or column headings. Some accountants follow a similar policy when the financial statements for all periods are unaudited but the level of service differs. The following illustrates disclosing the level of service in the financial statement headings when one period has been compiled and another has been reviewed.

XYZ CORPORATION
STATEMENTS OF ASSETS, LIABILITIES, AND EQUITY—INCOME TAX BASIS
December 31, 20X2 (Reviewed)
and 20X1 (Compiled)

If one of the periods is audited and the other unaudited, disclosure in the heading would be as follows:

XYZ CORPORATION
STATEMENTS OF ASSETS, LIABILITIES, AND EQUITY—INCOME TAX BASIS
December 31, 20X2 (Audited)
and 20X1 (Unaudited)

The use of *unaudited* may be replaced with *compiled* or *reviewed*, as appropriate.

Captions within the Financial Statements

Captions are headings within a statement that designate major groups of accounts to be totaled or subtotaled, e.g., Assets, Liabilities, and Stockholders' Equity on the statement of assets, liabilities, and equity. Captions also are used to identify major totals or subtotals.

AU-C 800 and the SSARS are silent regarding captions to be used in a special purpose framework presentation. As such, there is no requirement to modify GAAP captions for inclusion in a special purpose framework presentation. Accountants may modify captions if they desire, however. AICPA Technical Question and Answer Q&A 1500.04 provides the following examples of modified captions:

- *Cash Basis*
 - Excess of Revenue Collected over Expenses Paid
 - Excess of Expenses Paid over Revenue Collected
 - Accumulated Excess of Revenue over Expenses Paid
- *Income Tax Basis*
 - Retained Earnings—Income Tax Basis
 - Net Income—Tax Basis

Chapter 3 of the AICPA Practice Aid provides similar guidance, and further indicates that many preparers prefer to modify captions within special purpose financial statements as additional emphasis that the statements are not prepared under GAAP.

Order of Presentation. It is a best practice to present captions in the statement of assets, liabilities, and equity in the following order:

- a. *Assets.* Start with items held primarily for conversion into cash and rank them in the order of their expected conversion. Follow with items held primarily for use in operations but that could be converted into cash, and rank them in the order of liquidity. Finish with items whose costs will be deferred to future periods or that could not be converted into cash.
- b. *Liabilities.* Liability captions ordinarily are presented in the order of maturity of the liabilities.

- c. *Equity.* If the entity is a corporation, prevalent practice is to present the components of stockholders' equity in the following order:

- (1) Preferred stock
- (2) Common stock
- (3) Additional paid-in capital
- (4) Retained earnings
- (5) Accumulated other comprehensive income
- (6) Treasury stock

If the entity is not a corporation, the equity section of the statement of assets, liabilities, and equity should be modified to appropriately reflect the type of entity.

There are few strict rules regarding the appropriate format for a statement of revenues and expenses. In an income statement presented under generally accepted accounting principles, only unusual or infrequent items, discontinued operations of a component of an entity, equity in operations of investees, and consolidated net income and net income attributable to the parent and the noncontrolling interest are required to be presented separately. Lesson 2 provides additional guidance on presentation requirements for special purpose framework financial statements, including a discussion of presenting unusual or infrequent items and accounting changes in those financial statements.

If a statement of cash flows is presented, it is a best practice to order the major captions within the statement as follows:

- a. Operating activities
- b. Investing activities
- c. Financing activities

Lesson 2 provides additional guidance on the presentation of a statement of cash flows in special purpose framework financial statements.

Accounting Policies in Captions. Some accounting policies for statement of assets, liabilities, and equity accounts may be disclosed through expanded captions. For example, the method of pricing inventories may be disclosed using a balance sheet caption such as "Inventories, at lower of LIFO or net realizable value." It is better to use that type of disclosure only when it may be done without creating a cluttered appearance.

Captions without Amounts. Captions within the statement of assets, liabilities, and equity may be used solely to direct the reader to the notes. For example, a caption such as "Commitments and Contingencies" may be inserted on the statement between the liabilities and stockholders' equity sections. It is not a good idea to use captions without amounts, however, since that may confuse the reader and create a cluttered appearance.

Classified versus Unclassified Presentation

Classified statements of assets, liabilities, and equity present current assets and current liabilities separately from other assets and liabilities. Because they disclose the components of working capital, they are considered more useful to users than unclassified statements. In some industries, however, presenting an unclassified statement is preferable practice because the working capital distinction is not relevant. It is a good idea to present a classified statement unless an unclassified presentation is accepted industry practice.

It is a best practice to apply GAAP, when relevant, to special purpose framework financial statements. Accordingly, the following guidance for separating current and noncurrent items specified by FASB ASC 210-10-45; 310-10-45-9

should be followed when preparing a classified special purpose framework statement of assets, liabilities, and equity:

- a. **Current Assets.** Current assets include cash and other assets that are reasonably expected to be realized in cash or sold or consumed during one year or within the company's normal operating cycle if it is longer than a year. [An entity's operating cycle is the time needed to convert cash first into materials and services, then into products, then by sale into receivables, and finally by collection back into cash. In some industries, products have to mature, age, or otherwise undergo an extended conversion period (for example, distilleries, tobacco, forest products, and shipbuilding), and the cycle goes beyond a year. However, most companies have several cycles per year or no recognizable cycle. If the operating cycle is shorter than a year or is not determinable, a one-year period is used for both assets and liabilities. If the operating cycle exceeds a one-year period, common practice is to use the operating cycle for classifying assets as current, but to apply a one-year period for classifying liabilities.]
- b. **Current Liabilities.** Current liabilities are obligations that will be liquidated by using current assets or creating other current liabilities. Current liabilities include—
 - (1) Noncurrent obligations that, by their terms, are due on demand or will be due on demand within one year (or operating cycle, if longer) from the statement of assets, liabilities, and equity date, even if their liquidation is not expected within that period.
 - (2) Noncurrent obligations that are callable by the creditor because (a) the debtor is in violation of a provision of the debt agreement at the statement of assets, liabilities, and equity date or (b) a violation has occurred at the statement of assets, liabilities, and equity date that, if not cured within a specified grace period, will make the obligation callable.

A current liability that is expected to be refinanced on a long-term basis may be classified as noncurrent if the debtor intends to refinance the liability on a long-term basis and has demonstrated the ability to do so. 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.

Referencing Notes

There is no requirement to reference the financial statements to the notes, although it is common practice to do so. It is a best practice to reference each financial statement to the notes, either by reference to specific items in the financial statements (a practice followed by many firms in the interest of clarity) or by a general reference to the notes (usually shown at the bottom of the page). Using only a general reference is a good idea because it reduces both professional time and administrative time in production and eliminates the likelihood of referencing errors. The following are examples of general references to the notes: (Note that the references are the same as those included in GAAP financial statements.)

- See accompanying notes.
- See notes to financial statements.
- The accompanying notes are an integral part of these financial statements.
- See notes to consolidated financial statements.

If only one financial statement is presented, the reference might refer to the statement by name rather than to the "financial statement." For example, when only a statement of assets, liabilities, and equity is presented, the reference could appear as "See notes to statement of assets, liabilities, and equity—income tax basis." Also, if an individual financial statement extends beyond a single page, it is a best practice for only the last page to include a reference to the notes.

While any of the preceding references are acceptable, a good option is to use "See accompanying notes" because it may be used unmodified for almost any combination of financial statements. The reference can start at the left margin and be capitalized and punctuated as a sentence.

When a note that is presented directly on the face of a financial statement also applies to other financial statements, it is a best practice to include a reference such as "See Note A on the statement of assets, liabilities, and equity—income tax basis" on the other statements.

When compiled financial statements exclude substantially all disclosures but include selected notes, it is a good idea to refer to the selected notes on the financial statements by including a phrase such as "See accompanying selected information."

Referencing the Report

The SSARS do not require financial statements to include a reference to the related accountant's report. However, AR-C 80.A24 and AR-C 90.A66 both indicate that the accountant may choose to include such a reference on each page of the 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. Additionally, AR-C 80.A43 and AR-C 90.A13 include similar guidance for each page of supplementary information when the accountant reports on supplementary information. The examples given in the SSARS include, "See accountant's report," "See accountant's compilation report," or "See independent accountant's review report."

If the statements include notes, the reference can be expanded to include the notes. For example, in a compilation engagement, the reference could read, "See accompanying notes and accountant's report." Although the reference to accompanying notes is not specified by the SSARS, it seems to be a common practice for accountants to include such a reference if the financial statements include notes.

Audit literature also does not require a reference to the auditor's report on each page of the financial statements. It is a best practice, however, to include a reference to the notes on the bottom of each page of audited financial statements.

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 using a legend with wording such as "No assurance is provided on these financial statements." AR-C 70.14 discusses the requirements if the accountant is unable to place the statement on the financial statements.

Column Headings

Because the statement headings include the date or period covered, column headings are not necessary in single-period financial statements. When comparative statements are presented, however, the column headings should be identified by year, as illustrated by the following:

	20X2	20X1
ASSETS		
CURRENT ASSETS		
Cash	\$ 32,000	\$ 28,000

Using the year as the column heading in comparative statements does not properly distinguish the periods when they cover a different number of months (for example, the three months and six months ended June 30, 20X2). In such cases, headings such as the following may be appropriate:

ABC COMPANY
STATEMENTS OF REVENUES AND EXPENSES—INCOME TAX BASIS
Three Months and Six Months Ended June 30, 20X2

	Three Months	Six Months
NET SALES	\$ 1,057,000	\$ 2,327,000

When the level of service provided differs for each period presented (for example, one period is audited and the other is compiled), many practitioners use the column headings to indicate the level of service provided, as illustrated by the following:

ABC COMPANY
STATEMENTS OF ASSETS, LIABILITIES, AND EQUITY—INCOME TAX BASIS
December 31, 20X2 and 20X1

	20X2	20X1 (Unaudited) or (Compiled)
ASSETS		
CURRENT ASSETS		
Cash	\$ 32,000	\$ 28,000
Inventory	122,000	119,000

This course recommends that each column heading be centered over the column and underlined with the underline extending the width of the column. For consistency, it is helpful for the columns to be approximately the same width as the largest number in the column plus the additional spaces for the dollar sign; therefore, unusually long headings should be presented on two or more lines. Furthermore, the same width should be used for each column when multiple columns are presented and one line should be skipped between the last line of the column heading and the first caption of the statement.

Flexibility in Formatting the Financial Statements

A variety of presentation formats may be used in preparing special purpose financial statements. For example, statements of assets, liabilities, and equity may be presented in an account (side by side) format listing assets on the left hand side and liabilities and equity on the right hand side. Alternatively, a report (running) format may be used in which assets are listed at the top of the page followed by liabilities and equity. Similarly, statements of revenues and expenses may be presented in a single-step format that groups the components of net income into the two broad groups of revenues and gains, and expenses and losses, or in a multiple-step format that shows various intermediate components of net income (that is, operating revenues and expenses, grouped by type or function, presented separately from nonoperating revenues, gains, expenses and losses). In all cases, the primary consideration in selecting financial statement formats is that the financial statements present the information in a manner that can be easily understood by the reader. Consequently, the exact design and format of the financial statements should be governed by the needs of the expected users.

Accountants using certain accounting software packages may face limitations when preparing financial statements. Such limitations can include format restrictions, account title character limitations, or predefined financial statement titles. It is important to ensure that financial statement titles are revised appropriately based on the applicable financial reporting framework. Not doing so can result in peer reviewers identifying that situation as a matter for further consideration during the firm's peer review. As practitioners encounter such problems, they often

have presentation questions regarding these financial statements. Many accounting software packages will allow reports and/or financial statements to be exported as Excel spreadsheets, which can then be easily manipulated to revise statement titles as needed.

SELF-STUDY QUIZ

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

1. How should an entity be identified on the title page?
 - a. Using the name from its charter.
 - b. By the legal form of the entity.
 - c. By the name of the CEO or president.
 - d. As the CPA firm's client.
2. The following CPAs are all creating auditor's reports. Which one has correctly addressed an issue related to either the required format and presentation considerations or those recommended by this course?
 - a. Alan prints his auditor's report on a plain piece of paper with no letter head to clutter the presentation.
 - b. Betty, a sole practitioner, uses the title "INDEPENDENT AUDITOR'S REPORT."
 - c. Carlos does not include addressees on his audit reports.
 - d. Donna includes addresses for each of the branch locations of her firm.
3. Typically, what type of caption would be presented first in the statement of assets, liabilities, and equity?
 - a. Assets.
 - b. Liabilities.
 - c. Equity.
 - d. The entity can choose which one to present first.
4. Which of the following statements best describes an issue related to the presentation of basic financial statements using a special purpose framework?
 - a. Unclassified financial statements are considered more useful than classified financial statements.
 - b. Captions must contain specific financial information.
 - c. Financial statements are required to refer to the related accountant's report.
 - d. More than one format is acceptable for a presentation made using a special purpose framework.

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. How should an entity be identified on the title page? **(Page 94)**
 - a. **Using the name from its charter. [This answer is correct. The name of the entity should be presented exactly as listed in its charter, or appropriate legal document.]**
 - b. By the legal form of the entity. [This answer is incorrect. The legal form of the entity—for example, trust, estate, nonprofit organization, or S corporation—should be disclosed if not apparent from the entity's name. The title page is one place that this disclosure can be made. However, the entity's actual name does need to be included, as well.]
 - c. By the name of the CEO or president. [This answer is incorrect. A name would be used for personal financial statements, but an entity would not be identified by a person's name, even if it is the person in charge of the entire entity.]
 - d. As the CPA firm's client. [This answer is incorrect. The title page of the financial statements identifies the entity/client. The CPA firm's name will be included on the accountant or auditor's report.]
2. The following CPAs are all creating auditor's reports. Which one has correctly addressed an issue related to either the required format and presentation considerations or those recommended by this course? **(Page 98)**
 - a. Alan prints his auditor's report on a plain piece of paper with no letter head to clutter the presentation. [This answer is incorrect. Although there is no requirement to do so, it is a best practice for the accountant's or auditor's report to be presented on the firm's letterhead. The use of firm letterhead adds the formality that reflects the professional approach to association with financial statements. Therefore, while Alan does not have to do this under the standards, based on the guidance in this course, doing so would be preferred.]
 - b. **Betty, a sole practitioner, uses the title "INDEPENDENT AUDITOR'S REPORT." [This answer is correct. AU-C 700, *Forming an Opinion and Reporting on Financial Statements*, at AU-C 700.23, indicates that reports on audited financial statements should use a title that includes the word "independent." This course suggests using "INDEPENDENT AUDITOR'S REPORT" as the title of audit reports, such as the one Betty is working on in this scenario. There is no authoritative guidance about where the apostrophe should go in the word "auditor's." However, according to the AICPA Technical Question and Answer (Q&A 9160.25), sole practitioners often use singular terms, as Betty did in this scenario.]**
 - c. Carlos does not include addressees on his audit reports. [This answer is incorrect. Audit reports should be addressed as appropriate in the circumstances of the engagement. Routinely omitting addressees would not be a best practice for this type of report.]
 - d. Donna includes addresses for each of the branch locations of her firm. [This answer is incorrect. According to AICPA Technical Question and Answer at Q&A 9100.08, the auditor needs to indicate the city and state of the location that is issuing the report. Including all branch offices, be it manually or on letterhead, would not clarify that issue. Therefore, Donna needs to specifically indicate the city and state of her particular office in her report.]

3. Typically, what type of caption would be presented first in the statement of assets, liabilities, and equity? **(Page 105)**
- a. **Assets. [This answer is correct. This course suggests that the captions in the statement of assets, liabilities, and equity be presented in the following order: assets, liabilities, and equity. The captions related to assets would start with items held primarily for conversion to cash and rank them in order of their expected conversion.]**
 - b. Liabilities. [This answer is incorrect. According to the recommendations provided in this course, captions related to liabilities would be presented second.]
 - c. Equity. [This answer is incorrect. Captions related to equity would be presented third, per the recommendations made by this course. The first type of equity listed would be preferred stock.]
 - d. The entity can choose which one to present first. [This answer is incorrect. Based on the guidance provided in this course, it is preferable to present one of the above (assets, liabilities, or equity) first on this type of financial statement.]
4. Which of the following statements best describes an issue related to the presentation of basic financial statements using a special purpose framework? **(Page 109)**
- a. Unclassified financial statements are considered more useful than classified financial statements. [This answer is incorrect. Classified financial statements of assets, liabilities, and equity present current assets and current liabilities separately from other assets and liabilities. Because they disclose the components of working capital, they are considered more useful to users than unclassified statements.]
 - b. Captions must contain specific financial information. [This answer is incorrect. Captions within the statement of assets, liabilities, and equity may be used solely to direct the reader to the notes.]
 - c. Financial statements are required to refer to the related accountant's report. [This answer is incorrect. The SSARS do *not* require financial statements to include a reference to the related accountant's report. However, AR-C 80.A24 and AR-C 90.A66 both indicate that the accountant may choose to include such a reference on each page of the 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.]
 - d. **More than one format is acceptable for a presentation made using a special purpose framework. [This answer is correct. A variety of presentation formats may be used in preparing special purpose financial statements. In all cases, the primary consideration in selecting financial statement formats is that the financial statements present the information in a manner that can be easily understood by the reader.]**

NOTES TO THE FINANCIAL STATEMENTS

General

Notes are used to present material disclosures not otherwise presented in the statements. They are an integral part of the financial statements and, as such, are the responsibility of the client (even though the practitioner may assist with, or totally prepare, the statements and notes). Consequently, to avoid any reference to the CPA, this course recommends avoiding words such as “we,” “us,” “client,” and “our” in the notes. Instead, the notes can refer to the client using terms such as “the Company,” “the Corporation,” or “Management.”

Notes for comparative financial statements generally should cover all periods presented to the extent they remain relevant.

Format

Generally, notes are accumulated and presented as a separate page or pages after the basic financial statements. When there are only a few notes, however, 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 the note (such as “See Note A on the statement of assets, liabilities, and equity—income tax basis”) should be made on those statements.

In any event, it is a best practice to arrange the notes in the same order as the amounts in the statements to which they relate, and including a descriptive caption for each that corresponds to a statement of assets, liabilities, and equity or statement of revenues and expenses caption. The following additional guidelines will help if that approach is used:

- If a note addresses items in more than one statement, its placement would be determined by the first statement that would ordinarily be encountered. For example, a note providing disclosure of assets and liabilities under capital leases and rent expense under operating leases would be placed with asset notes.
- Commitments and contingencies liabilities notes would be placed between liabilities and equity notes.
- A subsequent events note would be the last note.

Title

When the notes are presented on separate pages rather than on the face of the statements, it is a best practice for the first page of the notes to be appropriately titled as follows:

ABC CORPORATION
NOTES TO FINANCIAL STATEMENTS

The format and capitalization policy of the note heading should be consistent with that used for heading the financial statements. This course uses the caption “NOTES TO FINANCIAL STATEMENTS” with no date because notes relate to the accompanying statements, each of which is dated. In practice, however, some firms present the statement of assets, liabilities, and equity date in the caption.

When a single statement is presented and notes are presented on separate pages, it makes more sense for the title to include the name of the statement rather than the general term “financial statements.”

ABC CORPORATION
NOTES TO STATEMENT OF ASSETS, LIABILITIES, AND EQUITY—INCOME TAX BASIS

When compiled financial statements include selected notes but exclude substantially all other disclosures, the selected pages of the notes can be labeled as follows:

ABC COMPANY
SELECTED INFORMATION—Substantially All Disclosures Required by the Income Tax Basis of
Accounting Are Not Included

Heading Individual Note Captions

This course recommends starting the note caption at the left margin and using the following style for headings of individual notes within the “Notes to Financial Statements” section.

NOTE C—PROPERTY AND EQUIPMENT

Using letters of the alphabet to identify notes rather than numbers seems to soften what otherwise may appear to be an overwhelming sea of numbers. Also, the entire note caption is capitalized, setting off the title from the text of the notes and facilitating location of specific notes.

Summary of Significant Accounting Policies

The summary of significant accounting policies is generally presented as the first note to the financial statements. The caption recommended by this course (and most commonly used in practice) is “NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES.” The summary of significant accounting policies note typically is divided into subsections for each specific policy or financial statement caption discussed. The format used in this course includes initial caps and underlining of subcaptions. For example—

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Date of Management's Review

Nature of Operations

Basis of Accounting

Use of Estimates

Inventories

Property and Equipment

Referencing Accounting Standards in the Notes

FASB ASC 105-10-05-5 indicates 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, it seems logical not to cite them in disclosures to the financial statements. Thus, any illustrative notes in this course follow this guideline. However, in practice, some financial statement preparers may refer to individual ASUs when discussing changes in accounting and disclosure requirements. Practice can be expected to evolve in this area.

SUPPLEMENTARY INFORMATION OR OTHER INFORMATION THAT COULD BE INCLUDED

General

Special purpose framework financial reports may include a variety of information that supplements the financial statements, such as detailed schedules, summaries, comparisons, or statistical information. Such information often is prepared especially for creditors or to comply with regulatory guidelines. Supplementary information may also be prepared to provide information about key factors for the entity's business.

The following recommendations can help distinguish between what to include in the financial statements and what to present as supplementary information:

- Include in the financial statements only what is required for a fair presentation in conformity with the applicable special purpose framework. As a practical matter, however, some entities prefer that, in addition

to amounts, financial statements include percentages for line items, typically the percentage of expense line items to sales. Percentages presented in the financial statements do not seem to constitute supplementary information for purposes of the reporting requirements applicable to supplementary information.

- Any other information to be included in the financial report should be considered supplementary information and presented after the notes to the financial statements.

One advantage of this approach is that it facilitates preparing different financial reports for different users. For example, management may only want to issue the financial statements to suppliers, but may want to distribute the entire financial report to each of its managers. In other cases, the supplementary information may be distributed differently to various users. For example, if the supplementary information consists of schedules of components of line items in the financial statements and statements of revenues and expenses for each division, top management may receive copies of the entire financial report, but division managers may receive a financial report consisting of the financial statements and schedules of components of line items in those statements, but only the divisional statement of revenues and expenses that relates to their division.

There is no authoritative guidance on what may or may not be presented as supplementary information. Accordingly, it seems appropriate to include any information management believes will be useful for its purposes. It is important to remember, however, that most disclosures required by the special purpose framework should be provided in the face of the financial statements or in the notes to the financial statements. This can be illustrated using disclosures required when property and equipment is reported in special purpose financial statements. The components of property and equipment often are disclosed in the notes to the financial statements, and the statement of assets, liabilities, and equity shows a single line item using a caption such as “property and equipment.” Disclosing the components of property and equipment in the notes is acceptable because the notes are a part of the financial statements. Including the components of property and equipment with supplementary information rather than in the notes, however, would constitute a departure from the special purpose framework.

The supplementary information presented most often in special purpose framework financial reports typically consists of—

- a. Components of line items in the financial statements that are not required by the applicable special purpose framework to be disclosed.
- b. Additional financial information related to line items in the financial statements.
- c. Details of consolidation or combination.
- d. Trends information such as the following:
 - (1) Five-year summaries of financial results.
 - (2) Statistics.
 - (3) Graphics.
- e. Nonfinancial information.

Components of Line Items in the Financial Statements

Supplementary information may include schedules of the components of any of the line items in the financial statements. Examples for the—

- statement of assets, liabilities, and equity are the components of other assets, securities portfolios, and long-term debt.
- statement of revenues and expenses are the components of cost of goods sold, selling expenses, and general and administrative expenses.

Entities sometimes find that supplementary information about the components of their securities portfolio is helpful to readers of the financial report. Accordingly, they provide a supplementary schedule that lists each security and related information such as name of issue (e.g., Giant Conglomerate common stock), number of shares owned, cost, and market value.

This course recommends combining smaller notes payable, not naming lenders, and providing general descriptions of collateral in disclosures about notes payable that appear in the notes to the financial statements. However, entities sometimes present additional details in supplementary information. As an example, an entity with several installment notes secured by equipment may group them into a single line item in the long-term debt note using a caption such as "Installment notes secured by equipment and payable in monthly installments currently totaling approximately \$1,750, including interest at rates ranging from 6% to 8%." However, in a supplementary schedule titled "Analysis of Debt Obligations," it might list each note, showing the lender's name, the specific collateral, the monthly installment, the interest rate, and the maturity date.

Special purpose financial statements often include some details for major captions, such as the major components of general and administrative expenses. There are two main approaches to providing supplementary information about components of line items in that situation. To illustrate the approaches, assume that the statement of revenues and expenses shows the following line items for general and administrative expenses:

GENERAL AND ADMINISTRATIVE EXPENSES

Compensation
Interest
Rent
Retirement plans
Other

Under one approach, the supplementary schedule would show the components of one or more line items within that major caption, typically other general and administrative expenses. Under the second approach, the supplementary schedule would show all of the components of general and administrative expenses. Note that the second approach enables the components of each line item of general and administrative expenses to be shown. For example, the supplementary schedule could show different compensation categories such as officers and office personnel and rent by types of property such as offices and equipment, as well as the components of the "Other" caption.

Additional Financial Information Related to Line Items in the Financial Statements

Examples of this type of supplementary information include aging of accounts receivable and presentation of a FIFO-based statement of revenues and expenses when inventory in the financial statements is valued at LIFO.

Details of Consolidation or Combination

When an entity conducts business through subsidiaries, divisions, or branches, or as part of a controlled group, financial statements prepared on a consolidated or combined basis are often accompanied by supplementary information that provides details of information in the financial statements by individual entities, divisions, or branches.

Supplementary schedules that provide such details of financial statements are referred to as *consolidating* or *combining* financial statements and should be appropriately titled considering the following:

- a. Consolidating financial statements generally present the results for a parent and its subsidiaries. Examples of titles for consolidating financial statements are "consolidating statement of assets, liabilities, and equity—income tax (or cash) basis" and "consolidating statement of revenues and expenses—income tax (or cash) basis."
- b. Supplementary information showing details by other entity groupings, for example, by location or a group linked by common ownership, are referred to as *combining* financial statements. When combining financial statements are prepared, the individual statements should bear appropriate titles such as "combining

statement of assets, liabilities, and equity—income tax (or cash) basis” or “combining statement of revenues and expenses—income tax (or cash) basis.”

Trends Information

Accountants may provide trends information such as condensed summaries of statements of assets, liabilities, and equity and statements of revenues and expenses for five or more years, and key ratios for the same period. Users of financial statements often find that these presentations make the related financial statements more useful and easier to understand. Some entities present such information separately from the financial statements and “traditional” other financial information; however, others include them with other financial information.

Special purpose financial statements may also include financial information presented in the form of tables, charts, or graphs. It seems logical that such information would ordinarily be considered supplementary information and reported on as appropriate for compilation or review engagements or audit engagements.

Nonfinancial Information

Examples of nonfinancial types of supplementary information could include number of employees, production statistics such as pounds produced and pounds shipped, and operating statistics such as patient days by patient pay classification and patient occupancy. It is a good idea to group all nonfinancial information into a separate section rather than interspersing it with supplementary financial information.

Presentation

One good method is to present supplementary schedules after the basic financial statements and notes, preceded by a title page separating the information from the basic financial statements. (The title page need not repeat the company name and date—“SUPPLEMENTARY INFORMATION” can be typed in “all caps” and centered on a line above the center of the page.) Some practitioners believe the title page is unnecessary as a divider, particularly when a separate accountant’s report on the supplementary information is presented. Using a title page provides a clearer break between the basic financial statements and supplementary information, however. When a separate accountant’s (or auditor’s) report on the supplementary information is presented, it is a best practice to place the report immediately following the title page and before the supplementary information.

The order of presentation of supplementary schedules may vary widely but should follow some logical pattern. One such method is to present the schedules in the order in which the subjects appear in the basic financial statements.

Schedule Headings

These headings can include the company name, the title of the schedule, the special purpose framework used in preparing the schedule, and the date or period covered in the schedule headings. This style is consistent with the style used in heading the basic financial statements, except that descriptive titles that clearly distinguish the schedules from the basic financial statements are used. To avoid confusing the schedules with basic financial statements, this course does not refer to the schedules as “statements.” The following examples illustrate an acceptable format for the headings of supplementary information.

XYZ COMPANY
ANALYSES OF COST OF SALES—INCOME TAX BASIS
Years Ended December 31, 20X2 and 20X1

or

ABC COMPANY
SCHEDULES OF MARKETABLE SECURITIES—INCOME TAX BASIS
December 31, 20X2 and 20X1

It is a best practice to use a plural title if schedules are comparative and a singular title if a schedule for only one year is presented. If more than one schedule is presented on the same page, however, the heading “SCHEDULES” may be used.

Numbering Schedules

Some accountants prefer to number each schedule to facilitate cross-referencing from the basic financial statements. This course suggests that the basic financial statements should not include references to supplementary schedules because such references might lead users to believe that the information is a part of the basic financial statements. However, there is nothing in authoritative literature that precludes a cross-reference in the basic financial statements.

Numbering schedules may, however, facilitate identification of the other financial information in the accountant's or auditor's report on the supplementary information. If numerous supplementary schedules are presented, numbering the schedules may enhance their usefulness. A heading for a numbered schedule is illustrated as follows:

XYZ COMPANY
 SCHEDULE 1—ANALYSES OF COST OF SALES—INCOME TAX BASIS
 Years Ended December 31, 20X2 and 20X1

Reporting on Supplementary Information

When supplementary information accompanies compiled or reviewed special purpose financial statements, the accountant should describe in his or her report on the statements, or in a separate report, the degree of responsibility, if any, he or she is taking with regard to supplementary information.

When an auditor submits a document containing audited special purpose financial statements to his or her client or others, the auditor has a responsibility to report on all the information in the document. Accordingly, the auditor should either express an opinion on the supplementary information or disclaim an opinion on it.

An in-depth discussion of reporting on supplementary information is beyond the scope of this course. More information on this topic is available in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*.

Reference to Report

Neither the audit literature, nor the SSARS, require that a reference to the auditor's report be printed on each page of the supplementary information. Thus, this course does not use such a reference when supplementary information is presented with compiled, reviewed, or audited financial statements.

Reference in Engagement Letter

When accountants are asked to present supplementary information that accompanies financial statements, the engagement letter should include a statement indicating the accountant's level of responsibility with respect to the supplementary information.

OTHER MATTERS THAT CAN AFFECT FORM AND STYLE

Continuation Pages

Continuation pages generally include a heading. For example, if a statement of revenues and expenses takes two pages, each page should have an appropriate heading. It is not necessary, however, to use the word "continued," to subtotal numbers, or to otherwise cross-reference financial statements or notes that take more than one page. For example, notes to financial statements that take several pages would be presented as follows:

(First page of notes)

ABC CORPORATION
 NOTES TO FINANCIAL STATEMENTS

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

NOTE B—EQUIPMENT AND LEASEHOLD IMPROVEMENTS

NOTE C—DEBT

The Company's long-term debt consists of the following:

Note payable in quarterly installments of \$25,000 plus interest at \$ 500,000
prime plus 1%

(Second page of notes)

ABC CORPORATION
NOTES TO FINANCIAL STATEMENTS

Installment notes payable monthly with interest rates ranging from 10% to 15%	350,000
Revolving line of credit with interest rate at prime plus 2.5%	<u>150,000</u>
	<u>\$ 1,000,000</u>

While it is desirable for all pages to end at the same place, that often is not feasible. For example, a note may include a table that can be started toward the bottom of the page but would extend to the next page. Thus, the preparer may have to make a trade-off between even margins and making the statements easier to understand. Accordingly, the preparer may want to consider starting the table at the top of the next page even though there is a large space at the end of the preceding page. A table within a note could be divided at a logical point, such as a subtotal.

Dollar Signs

This course suggests placing a dollar sign before the first number in a column, before each double underlined number, and before the first number appearing in a column after a double underlined number. The dollar sign can be positioned at the left tab setting and followed with at least one space. The following illustrates:

	<u>20X2</u>	<u>20X1</u>
SELLING		
Advertising	\$ 100,000	\$ —
Commissions	75,000	70,000
Supplies	<u>15,000</u>	<u>10,000</u>
	<u>\$ 190,000</u>	<u>\$ 80,000</u>
GENERAL AND ADMINISTRATIVE		
Rent	\$ —	\$ 100,000
Commissions	75,000	70,000
Supplies	<u>125,000</u>	<u>120,000</u>
	<u>\$ 200,000</u>	<u>\$ 290,000</u>

If the column has no total, place a dollar sign beside the first number only, as follows:

20X3	\$ 100,000
20X4	100,000
20X5	105,200
20X6	123,000
20X7	126,900

Underlining and Spacing

Key totals and subtotals generally are presented within statements, schedules, and notes. Underlining helps the reader follow the flow of the numbers and highlights key totals. Appropriate spacing policies are as follows:

- The underline extends the full width of the column (i.e., from the dollar sign to the last number on the right in the column).
- Each time a subtotal is presented, the number above the subtotal should be single underlined. The subtotal would be followed by a line skip when it is captioned or it is the last number of the major caption. When it is a major caption subtotal, it is both preceded and followed by a line skip. For example, a subtotal of inventory would be immediately followed by prepaid expenses with no line skip before or after, while a line would be skipped after a subtotal of net property and equipment, and a line would be skipped before and after the total current assets subtotal.
- Each time a grand total is presented, it should be double underlined. The lines above and below the grand total should be skipped, and the number above the grand total should be single underlined.

The preceding underlining and spacing policies are illustrated in the partial statement of assets, liabilities, and equity that follows:

ABC COMPANY
STATEMENTS OF ASSETS, LIABILITIES, AND EQUITY—INCOME TAX BASIS
December 31, 20X2 and 20X1

	<u>20X2</u>	<u>20X1</u>
CURRENT ASSETS		
Cash	\$ 32,000	\$ 28,000
Marketable securities, at cost	260,000	245,000
Inventory		
Finished goods	122,000	119,000
Work in process	36,000	42,000
Raw materials and supplies	<u>52,000</u>	<u>44,000</u>
	210,000	205,000
Other	<u>1,000</u>	<u>1,000</u>
	<u>503,000</u>	<u>479,000</u>
TOTAL CURRENT ASSETS	503,000	479,000

PROPERTY AND EQUIPMENT		
Land and land improvements	70,000	70,000
Buildings	1,125,000	1,030,000
Machinery and equipment	<u>820,000</u>	<u>775,000</u>
	2,015,000	1,875,000
Accumulated depreciation	<u>(485,000)</u>	<u>(333,000)</u>
	1,530,000	1,542,000
OTHER ASSETS		
	<u>59,000</u>	<u>40,000</u>
	<u>\$ 2,092,000</u>	<u>\$ 2,061,000</u>

Typically, the following numbers in basic financial statements will be double underlined:

Statement of Assets, Liabilities, and Equity

- Total of all assets
- Total of all liabilities and stockholders' equity

Statement of Revenues and Expenses

- Net income

Statement of Revenues, Expenses, and Retained Earnings

- Retained earnings at the end of the period

Statement of Cash Flows (If Presented)

- Cash and cash equivalents at the end of the period

In the notes to the financial statements, the total of any tables presented should be double underlined. Tables not disclosing a total would not require double underlining. (A table presented within the notes to the financial statements should be centered on the page under the note to which it pertains.)

Zeros in a Column

If the number to be presented for a line item is zero, the preparer has three options:

- Present a zero.
- Use a dash or hyphen to represent zero.
- Leave the space blank.

Using a dash acknowledges that a number is expected and has not been overlooked. Also, a page with numerous dashes does not appear as cluttered (or as negative) as a page full of zeros (-0-). The previous illustration in the "Dollar Signs" discussion demonstrates using a dash for a zero. The formatting of dashes should be consistent throughout the financial report.

Use of Brackets

Readers of financial statements should be expected to understand the basic mathematical exercises involved in financial statements. As an example, they should understand that taxes are subtracted from pretax earnings to

arrive at net income and that cost of sales is subtracted from sales to arrive at gross profit. Accordingly, brackets should not be used each time one number or subtotal is subtracted from another. However, it is generally appropriate to use brackets to represent negative numbers when a line, column, or subtotaed grouping includes both positive and negative numbers. When brackets are used, there is no need to precede the caption with the word "less" since the brackets notify the reader that the number is to be subtracted, for example, "accumulated depreciation" rather than "less accumulated depreciation."

Brackets often are used to distinguish negative numbers in statements of assets, liabilities, and equity when accumulated depreciation, the current portion of long-term debt, treasury stock, and retained earnings deficits are presented in subtotaed groupings of otherwise positive numbers. The use of brackets is less predictable in statements of revenues and expenses and statements of cash flows.

Lines Having Both a Positive and a Negative Number

A line item may show a positive number for one year and a negative number for the other. When appropriate, the description of the line item should be revised to reflect that fact, for example, "Income (Loss) before Income Taxes." If a reader would expect a particular description, the caption should consist of that description followed by a bracketed description of what the negative number represents. That applies even if the negative number appears in the current year, as illustrated by the presentation of the income tax benefit in the following example:

	20X2	20X1
REVENUES	\$ 9,000,000	\$ 8,000,000
COSTS AND EXPENSES		
Cost of goods sold	4,000,000	4,000,000
Selling expenses	1,000,000	800,000
General and administrative expenses	4,500,000	3,100,000
	<u>9,500,000</u>	<u>7,900,000</u>
INCOME (LOSS) BEFORE INCOME TAXES	(500,000)	100,000
INCOME TAXES (TAX BENEFIT)	<u>(170,000)</u>	<u>34,000</u>
NET INCOME (LOSS)	(330,000)	66,000
BEGINNING RETAINED EARNINGS	<u>106,000</u>	<u>40,000</u>
ENDING RETAINED EARNINGS (ACCUMULATED DEFICIT)	<u>\$ (224,000)</u>	<u>\$ 106,000</u>

Increase and decrease captions customarily should begin with "Increase." In the caption, brackets should appear around increase or decrease as applicable. The following illustrates application of that policy:

	<u>20X2</u>	<u>20X1</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	\$ (10,000)	\$ 25,000
Adjustments to reconcile net income (loss) to net cash provided by operating activities		
Depreciation	15,000	15,000
(Increase) decrease in accounts receivable	10,000	(20,000)
Increase (decrease) in accounts payable	<u>17,000</u>	<u>(12,000)</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u><u>32,000</u></u>	<u><u>8,000</u></u>

If a number is negative in both years, brackets should appear around both numbers but not in the caption. For example—

	<u>20X2</u>	<u>20X1</u>
LOSS BEFORE INCOME TAX BENEFIT	(3,000)	(6,000)
INCOME TAX BENEFIT	<u>(1,000)</u>	<u>(2,000)</u>
NET LOSS	<u><u>\$ (2,000)</u></u>	<u><u>\$ (4,000)</u></u>

Rounding

It is a best practice for numbers in financial statements and schedules to ordinarily be in whole dollars. Presentation of cents takes additional space without providing the reader with any useful information.

For some presentations, it may be appropriate to round higher than the nearest dollar. A common example is forecasted information for which the use of dollars implies a much greater precision than actually exists. In addition, some entities may find that the primary users prefer historical presentations that have been rounded to the nearest hundred dollars because they are actually easier for users to evaluate and discuss. When numbers have been rounded higher than the nearest dollar, preparers can add the parenthetical phrase "(Rounded to the Nearest Hundred Dollars)" as the last line in the page heading as follows:

XYZ COMPANY
STATEMENTS OF ASSETS, LIABILITIES, AND EQUITY—INCOME TAX BASIS
December 31, 20X2 and 20X1
(Rounded to the Nearest Hundred Dollars)

Whether or not the financial statements are rounded, it is good practice to round amounts that represent estimates, such as income tax provisions computed before the tax return is prepared.

When numbers are rounded to the nearest dollar or higher, the individual rounded amounts should, nevertheless, equal the amounts of totals and subtotals. For example, rounded net income added to rounded beginning retained earnings should equal rounded ending retained earnings. Similarly, rounded components of an expense account should add to the total.

It seems appropriate to round amounts presented in the notes to financial statements. When an amount has been rounded in the notes, it can be preceded by the word "approximately" to notify the reader. As an example, a note disclosing transfers of receivables with recourse that have been reported as sales might read:

Proceeds from transfers of receivables with recourse reported as sales totaled approximately \$750,400.

Notes that are designed to balance to amounts presented in the statements should, of course, follow the same rounding policy as used for the amount in the statement.

Use of Percentages

Presentations of percentages often provide useful information. It is a best practice for percentages to normally show no more than tenths, and to generally be in whole numbers. Percentages that show hundredths clutter the presentations and normally will be rounded by readers in their evaluation.

Adopting a consistent policy for presenting percentages in narrative presentations, such as debt disclosures, can result in a better appearance. Since most debt agreements express uneven percentages using fractions, it is a best practice for all such percentages included in narrative presentations should be presented using fractions. The following illustrates that policy:

The note is secured by equipment and bears interest at a rate that fluctuates between a minimum of 10% and a maximum of prime plus $\frac{1}{4}\%$.

Page Numbers

Page numbers can be included in the financial statements whenever a table of contents is used. In such cases, page numbers should be assigned to every page in the financial report except for the table of contents and the page introducing the other financial information. The page number will be easily readable if it is centered two or three lines from the bottom of the page. Page numbers are not necessary when a table of contents is not used.

SELF-STUDY QUIZ

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

5. How are special purpose financial statements and reports affected by supplementary information?
 - a. They are not allowed to include supplementary information since they are not prepared on the GAAP basis.
 - b. Such information would most likely be included to provide information about key factors of the entity's business.
 - c. Information that is not required for fair presentation in the financial statements should be included as supplementary information.
 - d. Supplementary information should be placed first in the financial statement presentation.
6. According to the form and style suggestions presented in this course, if a line item number in the financial statements is zero, how should it be displayed?
 - a. As a zero.
 - b. As a dash or hyphen.
 - c. As a blank space.
 - d. As a zero in brackets.

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. How are special purpose financial statements and reports affected by supplementary information? **(Page 115)**
 - a. They are not allowed to include supplementary information since they are not prepared on the GAAP basis. [This answer is incorrect. Special purpose framework financial reports may include a variety of information that supplements the financial statements, such as detailed schedules, summaries, comparisons, or statistical information.]
 - b. Such information would most likely be included to provide information about key factors of the entity's business. [This answer is incorrect. While supplementary information can be prepared to provide information about key factors for the entity's business, it is more often prepared especially for creditors or to comply with regulatory guidelines.]
 - c. **Information that is not required for fair presentation in the financial statements should be included as supplementary information. [This answer is correct. Based on the recommendations provided by this course, the financial statements should include only what is required for a fair presentation in conformity with the applicable special purpose framework. Any other information to be included in the financial report should be considered supplementary information.]**
 - d. Supplementary information should be placed first in the financial statement presentation. [This answer is incorrect. As discussed in this course, it is a best practice for supplementary information to be presented after the financial statements and the financial statement notes.]
6. According to the form and style suggestions presented in this course, if a line item number in the financial statements is zero, how should it be displayed? **(Page 122)**
 - a. As a zero. [This answer is incorrect. A page full of zeros looks more cluttered and more negative. This course recommends a different method.]
 - b. **As a dash or hyphen. [This answer is correct. If the number to be presented for a line item is zero, the preparer has three options: (1) present a zero, (2) use a dash or hyphen to represent zero, and (3) leave the space blank. This course suggests using a dash because it acknowledges that a number is expected and has not been overlooked. However, using a dash is also less cluttered and easier to read than other options. If used, the formatting of dashes should be consistent throughout the financial report.]**
 - c. As a blank space. [This answer is incorrect. Using a blank space is not recommended by this course, as readers could wonder if a number in that line item was overlooked or left off by mistake.]
 - d. As a zero in brackets. [This answer is incorrect. Brackets can be used to represent negative numbers when a line, column, or subtotaled grouping includes both positive and negative numbers. However, they would not be used around a zero.]

Lesson 2: Disclosures in Special Purpose Framework Presentations

INTRODUCTION

Authoritative accounting literature does not address bases of accounting other than GAAP or the disclosures necessary in such presentations. Guidance on disclosing information in such presentations can be found in both the auditing literature and the SSARS, however.

Auditing Literature

AU-C 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, at AU-C 800.15 requires auditors to evaluate whether special purpose financial statements are suitably titled, include a summary of significant accounting policies, and adequately describe differences between the special purpose framework and GAAP. Lesson 1 discusses basic financial statements for special purpose frameworks, including financial statement titles. The summary of significant accounting policies is further discussed later in this lesson. Describing differences between the special purpose framework and GAAP is covered as needed in this course.

AU-C 800.17 requires that when special purpose financial statements include items that are the same as or similar to those in financial statements prepared under GAAP, the auditor should evaluate whether the special purpose financial statements include informative disclosures similar to those required by GAAP. Also, the auditor should evaluate whether additional disclosures, beyond those specifically required by the framework, that are related to matters not specifically identified on the face of the financial statements, or other disclosures, are necessary for the financial statements to achieve fair presentation.

AU-C 800.A19 explains that achieving fair presentation includes providing all informative disclosures appropriate for the applicable financial reporting framework, including matters that affect the use, understanding, and interpretation of the financial statements. AU-C 800.A34, Appendix B, "Fair Presentation and Adequate Disclosure," offers more guidance on determining the adequacy of disclosures prepared using a special purpose framework, including examples of qualitative disclosure information and some GAAP disclosure requirements that would not be relevant to specific special purpose frameworks.

Additionally, AU-C 800.A21 indicates that special purpose financial statements may present disclosures using qualitative information instead of the quantitative information that GAAP requires or, alternatively, provide information that communicates the substance of those requirements. An example presented by the auditing standard states that disclosing estimated percentages of revenues, rather than amounts as required by GAAP, may adequately convey the significance of sales or leasing to related parties or major customers.

Compilation and Review 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. The SSARS indicate that for compiled or reviewed special purpose financial statements to be appropriate in form, they should include—

- A description of the special purpose framework, including a summary of significant accounting policies and a description of the primary 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 lesson

includes references to both the SSARS and auditing literature to provide information regarding disclosures in compilation and review engagements 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. Accordingly, this course is written with the perspective that the adequacy of disclosures in cash, modified cash, or income tax basis financial statements that are compiled or reviewed may be evaluated following the guidance in the SSARS, supplemented by guidance in the auditing literature that is more expansive.

The AICPA Practice Aid

The AICPA has a practice aid, *Accounting and Financial Reporting Guidelines For Cash- and Tax-Basis Financial Statements* (the AICPA Practice Aid), that provides nonauthoritative guidance about preparing financial statements using a cash basis or tax basis financial reporting framework. Information from the AICPA Practice Aid is considered in various discussions within this course. The AICPA Practice Aid is available from the AICPA at www.aicpastore.com.

Organization of This Lesson

Following the authoritative guidance discussed in the preceding paragraphs, it is a best practice to evaluate the disclosures necessary in cash, modified cash, and income tax basis presentations by (a) identifying the disclosures that would be required for a GAAP presentation, (b) deciding whether those disclosures are relevant to the basis of accounting used, (c) deciding whether the relevant GAAP disclosure requirements should be followed or alternative ways to communicate the substance of those requirements should be explored, and (d) evaluating whether any additional disclosures related to matters not specifically identified in the financial statements, or other disclosures, are necessary to achieve fair presentation. To apply this approach, Lesson 2 addresses the following five aspects of disclosure considerations:

- GAAP presentation requirements and their applicability to cash, modified cash, and income tax basis presentations;
- cash flows information;
- the summary of significant accounting policies;
- financial statement items for which GAAP would require disclosure; and
- other GAAP disclosures and their applicability to special purpose framework presentations.

In addition, this lesson—

- provides guidance on a change in the basis of accounting;
- provides guidance when the financial statements omit substantially all disclosures;
- discusses this course's approach to considering the measurement and disclosure principles of FASB ASC 810-10, *Consolidation*, and FASB ASC 740-10, *Income Taxes*, respectively; and
- provides information regarding other disclosure considerations, including presentation of tax information, fair value considerations, presenting combined or consolidated financial statements, and controlling or noncontrolling financial interests.

Specific recommendations for disclosures in cash or modified cash basis, tax basis, and regulatory basis financial statements or interim financial statements are beyond the scope of this course, but information on these topics can be found in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the presentation requirements for disclosures in special purpose framework presentations, as well as special considerations related to cash flows information, the summary of significant accounting policies,

financial statement items for which GAAP requires disclosure, and other information that GAAP would require disclosing.

- Identify the disclosure methods financial statements prepared using a special purpose framework should use for changes in financial reporting frameworks, the omission of substantially all disclosures, and the consolidation of variable interest entities.
- Determine the best way for financial statements prepared using a special purpose framework to disclose accounting for uncertainty in income taxes and how such financial statements should deal with other considerations, like fair value and noncontrolling financial interest.

APPLICABLE PRESENTATION REQUIREMENTS

Some generally accepted accounting principles prescribe how information is to be presented on the face of the financial statements. For example:

- a. FASB ASC 205-20-45-3 requires that income statements show the results of discontinued operations of a component of an entity net-of-tax as a separate component of income.
- b. Prior to the effective date of ASU 2016-14, FASB ASC 958-205-45-1 through 45-6 requires voluntary health and welfare organizations to issue a separate financial statement in a matrix format showing expenses according to their natural and functional classifications. It also requires all nonprofit organizations to classify net assets on the statement of financial position into three categories—permanently restricted, temporarily restricted, and unrestricted—and to present information in the statement of activities according to those categories. After the effective date of ASU 2016-14, those presentation requirements change. In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*, which, among other things, revises the guidance in FASB ASC 958-205-45-1 through 45-6. For example, it revises the requirements for reporting expenses by nature and function, and it changes the classification of net assets from three categories to two categories: net assets with donor restrictions and net assets without donor restrictions. The ASU goes into effect for annual financial statements issued for fiscal years beginning after December 15, 2017, and for interim periods within fiscal years beginning after December 15, 2018.

If special purpose financial statements contain amounts for which GAAP requires disclosure, then the financial statements should either comply with the requirements for a GAAP presentation or provide information that communicates the substance of those requirements. As previously mentioned, AU-C 800.A21 says that the substance of GAAP presentation requirements may be communicated using qualitative information. The following paragraphs discuss how the preceding GAAP presentation requirements affect the presentation of special purpose financial statements in light of the guidance in AU-C 800.

Unusual and/or Infrequent Items and Disposal of a Component of an Entity

GAAP requires the effects of unusual and/or infrequent items and disposal of a component of an entity to be reported net-of-tax apart from the results of ordinary operations. Cash, modified cash, or income tax basis financial statements may present those items in the same manner. Alternatively, they may communicate the objective of the GAAP presentation requirements, which is to separate the effects of those items because of their effect on the comparability of financial statements, without following the GAAP presentation requirements to the letter. For example, the special purpose financial statements could—

- a. present the results of a disposed component of an entity in a separate column of a cash basis presentation. (As a practical matter, if the information is not readily available, the disposed operations probably do not meet the requirements to be considered a component of the entity.)
- b. provide sufficient information for the financial statement reader to assess the effect of an unusual and/or infrequent loss by describing it in a note to tax basis financial statements.

Nonprofit Organizations

Prior to the effective date of ASU 2016-14, cash, modified cash, or income tax basis statements of nonprofit organizations can communicate the substance of the GAAP requirements to provide information about functional

expense categories and classes of net assets by (a) presenting a statement of functional expenses (if applicable) and classifying net assets and changes in net assets as unrestricted, temporarily restricted, and permanently restricted or (b) using alternative presentations such as the following:

- The income tax basis statement of activities of a trade organization could present expenses according to natural classifications because that is all that is required in its Form 990. A note to the financial statements could then communicate how expenses are incurred using estimated ratios, such as: "Approximately three-fourths of the Organization's expenses are incurred in connection with its programs. Program expenses are incurred approximately one-third each to provide continuing education, subsidies to members who are unable to work, and a variety of functions."
- Instead of presenting the separate financial statement matrix of natural and functional expense classifications, a voluntary health and welfare organization could present expenses in its tax basis statement of activities according to their functional classifications and present the major natural classifications in a note to the financial statements. The information could be taken from the Form 990 matrix.
- The tax basis financial statements of a performing arts organization could present information according to the fund balance approach taken in its Form 990. Information about restrictions and significant changes in restricted amounts could be provided in a note to the financial statements. That information could be provided using general descriptions. For example:

Substantially all of the short-term investments are restricted to completion of the new training facilities, and most of the contributions receivable are restricted to next year's operations. Contributions raised through the Capital Campaign started towards the end of last year and finished this year funded substantially all of the costs of the new training facilities.

After the effective date of ASU 2016-14, cash, modified cash, or income tax basis statements of nonprofit organizations can communicate the substance of the GAAP requirements for reporting expenses and classes of net assets by (a) reporting expenses by nature and function and classifying net assets and changes in net assets as net assets with donor restrictions and net assets without donor restrictions or (b) using alternative presentations such as the following:

- Instead of presenting the relationship between natural and functional expense classifications in a separate financial statement or a schedule in the notes to the financial statements, an organization could present expenses in its tax basis statement of activities according to their functional classifications and present the major natural classifications in a note to the financial statements. The information could be taken from the Form 990 matrix.
- The tax basis financial statements of a performing arts organization could present information according to the fund balance approach taken in its Form 990. Information about restrictions and significant changes in restricted amounts could be provided in a note to the financial statements. That information could be provided using general descriptions. For example:

Substantially all of the short-term investments are restricted to completion of the new training facilities, and most of the contributions receivable are restricted to next year's operations. Capital campaign contributions started towards the end of last year and finished this year funded substantially all of the costs of the new training facilities.

Classification of Assets and Liabilities

FASB ASC 210-10-05-5 does not require classifying balance sheets as current and noncurrent; it only indicates that most entities do so. Therefore, cash, modified cash, and income tax basis balance sheets do not need to be classified. As a practical matter, information about liquidity can be provided in other ways, such as presenting assets and liabilities in the order of liquidity and through note disclosure.

One Financial Statement Presented

Accountants are sometimes asked to present only one basic financial statement, for example, a statement of assets, liabilities, and equity without a statement of revenues, expenses, and retained earnings. In those situations, the accountant would present only the disclosures that relate to the financial statement presented. For example, if only a statement of assets, liabilities, and equity is presented, there would be no need to disclose depreciation expense. Also, accountants are sometimes requested to present a full set of basic financial statements for some users and a single financial statement, such as a statement of assets, liabilities, and equity, for others. In that situation, different sets of notes also should be prepared to provide a relevant presentation. Since that only involves eliminating some items from the notes of the full set of financial statements, it should not be costly or time-consuming. As discussed in Lesson 1, 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,” such as:

ABC CORPORATION
NOTES TO STATEMENT OF ASSETS, LIABILITIES, AND EQUITY—
INCOME TAX BASIS

If an entity is reporting on the pure cash basis of accounting, a single statement of cash receipts and disbursements is often used.

As a practical matter, accountants should consider whether readers of the financial statement will be misled by the omission of disclosures that would be provided by inclusion of the other financial statements. That requires judgment based on careful consideration of the facts and circumstances.

To illustrate, assume that the entity customarily presents a complete set of financial statements presented on the income tax basis and this year incurs a significant loss. If management decides to issue only a statement of financial position prepared on the income tax basis of accounting, the accountant should consider whether omission of disclosure of the loss would mislead the user.

- a. If the omission would not mislead the user, disclosure of the loss is unnecessary. For example, depending on the facts and circumstances, the accountant might conclude that the omission would not mislead the user if either the statement shows a significant accumulated deficit or the statement shows significant retained earnings and the loss is an aberration.
- b. However, the accountant might conclude that, depending on the facts and circumstances, the omission would mislead the user if the entity is likely to continue incurring losses. If the omission would mislead the user, the financial statements may disclose information about the loss.

This guidance also applies if substantially all disclosures are omitted. AR-C 80.26 permits compiling financial statements that omit substantially all disclosures only if the omission is not intended to mislead. The AICPA Guide, *Preparation, Compilation, and Review Engagements* (AICPA Guide) at Paragraph 2.80 indicates that AR-C 80 does not preclude the accountant from adding an emphasis-of-matter or an other-matter paragraph in the accountant's report. Thus, the compilation report on financial statements when substantially all disclosures are omitted, may include an other-matter paragraph even though the matter is not disclosed in the financial statements.

Perhaps more importantly, however, the accountant should carefully consider whether management intended to mislead the financial statement users and, if so, whether to continue association with the client. The accountant should consult with and follow the advice of legal counsel before terminating the relationship.

Presentation of Equity Interests the Entity Must Redeem upon the Owner's Death

FASB ASC 480-10, *Distinguishing Liabilities from Equity*, requires entities to treat as liabilities in their GAAP financial statements three types of financial instruments related to equity interests. Entities that issue special purpose financial statements are not likely to enter into two of those types, examples of which are put options that require settlement in cash or through the issuance of additional shares.

The third type of financial instrument covered by FASB ASC 480-10 is one that requires the entity to purchase or redeem equity shares at a particular date or upon an event that is certain to occur. The common agreement by a

corporation to redeem an equity interest upon a stockholder's death is an example of this type of financial instrument. Therefore, under FASB ASC 480-10, stock of corporations that must be redeemed upon the stockholder's death would ordinarily no longer be considered equity under GAAP but instead would be considered a liability.

However, FASB ASC 480-10-15-7A provides a scope exception of the classification, measurement, and disclosure requirements of FASB ASC 480-10 for mandatorily redeemable financial instruments that (a) are issued by nonpublic entities *and* (b) are not mandatorily redeemable on fixed dates or not for amounts that either are fixed or determined by reference to an interest rate index, currency index, or another external index. In July 2017, the FASB issued ASU 2017-11, *Earnings Per Share (Topic 260), Distinguishing Liabilities from Equity (Topic 480), Derivatives and Hedging (Topic 815): I. Accounting for Certain Financial Instruments with Down Round Features; II. Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception*, which recharacterized the indefinite deferral of certain provisions of Topic 480 to a scope exception. Because those amendments have no accounting effect, there is no effective date to consider for those amendments. That is, the change from an indefinite deferral to a scope exception is effective immediately.

To illustrate, under generally accepted accounting principles, stock of a nonpublic entity redeemable on a fixed date for a prescribed amount would be accounted for as a liability but stock redeemable on the death of the equity holder would be accounted for as equity. *PPC's Guide to Preparing Financial Statements* provides guidance on applying FASB ASC 480-10 in GAAP financial statements. For purposes of preparing special purpose financial statements, the requirements of FASB ASC 480-10 can be viewed as presentation requirements; when that view is taken, it seems logical that the substance of the required information may be communicated using qualitative information and without modifying the financial statement format. In most cases, communicating the substance of the information required by FASB ASC 480-10 only requires a note to the financial statements, or an expansion of the equity caption, that describes the redemption provision.

INFORMATION ABOUT CASH FLOWS

As previously mentioned, a statement of cash flows is not required for special purpose financial statements because they do not purport to present financial position and results of operations in accordance with GAAP. However, an entity following either the modified cash basis or income tax basis of accounting may choose to present a statement of cash flows. This discussion provides considerations for when an entity chooses to include a statement of cash flows with special purpose financial statements.

Cash flow presentations using a special purpose framework, such as the cash basis of accounting, often include a statement consisting entirely or mainly of cash receipts and disbursements. Such presentations often do not conform to GAAP requirements for a statement of cash flows. For example:

- a. Cash basis presentations normally show cash receipts and disbursements by major categories. Instead of presenting results in the three categories used in a statement of cash flows—operating, investing, and financing—the statement typically shows all receipts first, then all disbursements.
- b. Modified cash basis income statements typically use a format similar to cash basis presentations but include some noncash transactions along with cash transactions, such as depreciation, and exclude cash transactions that do not affect income such as reduction of long-term obligations.
- c. Presentations using the cash basis of accounting used for income tax reporting generally are similar to either cash basis or modified cash basis presentations.

However, a presentation of cash receipts and disbursements could resemble a statement of cash flows. For example, a cash basis presentation could be grouped according to operating, investing, and financing activities. Similarly, a modified cash basis presentation could show an excess of revenue collected over depreciation and interest and other expenses paid, add depreciation back to that excess to derive cash from operations, and subtract disbursements for equipment and principal reduction to derive the increase in cash.

If the presentation resembles a statement of cash flows or if the entity decides to include a statement of cash flows, AU-C 800.A34 indicates the presentation would either conform to the requirements for a GAAP presentation or

communicate the substance of the GAAP requirements. As a practical matter, the ability to communicate the substance of the requirements for a GAAP presentation generally is limited to disclosure of the major reconciling items between net income and cash from operating activities, disclosure of payments of interest and income taxes, and the presentation of certain transactions gross. As examples, a statement of cash flows included with financial statements prepared on the accrual basis of accounting used for income tax reporting might—

- report the net change in long-term debt in the statement and disclose the cash received from a new obligation in a note describing long-term debt. The note might not disclose principal reductions under the assumption that the financial statement reader could easily determine them.
- use the direct method to report cash flows from operating activities but, rather than present a reconciliation of net income to cash from operating activities, include a note to the financial statements showing the changes in the significant accounts and stating that changes in those accounts comprise most of the difference between net income and cash from operating activities.
- disclose the effect of noncash investing and financing activities through captions in the statement. For example, the investing activities section might have a caption such as “Equipment purchases, less purchases financed through a \$50,000 loan from First Bank.” Similarly, the financing activities section might have a caption such as “Proceeds from new long-term debt, less \$50,000 to finance equipment purchases.”

THE SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

AU-C 800.15 requires that the notes to the financial statements include a summary of accounting policies. AU-C 800.16 requires that when financial statements are presented using a contractual basis of accounting, any significant interpretations of the contract on which the financial statements are based should also be adequately described. AR-C 80.18–.19 and AR-C 90.40–.41 also include those requirements, indicating that the accountant's report should be modified when the financial statements do not include such information. FASB ASC 235-10-50 provides the requirements for GAAP basis accounting policies disclosure, which should be considered when determining what to disclose in the summary of significant accounting policies for special purpose financial statements. Accordingly, FASB ASC 235-10-50, AU-C 800, and the SSARS provide guidance on the summary of significant accounting policies for special purpose financial statements as explained below.

- 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) *Income tax basis*—“the basis of accounting used for federal income tax reporting” or “the accrual basis of accounting for income tax purposes”
 - (4) *Contractual basis*—“the basis of accounting used to comply with the financial reporting provisions of Section V of the contract”
- 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. AU-C 800.15 and AR-C 80.18 and AR-C 90.40 indicate that quantifying the effects of differences in the description of the basis is unnecessary. AU-C 800.A18, AR-C 80.A30, and AR-C 90.A82 further explain that the description of how the basis of accounting used to prepare the special purpose framework financial statements differs from GAAP ordinarily only includes the material differences between GAAP and the special purpose framework. 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 good idea to disclose the nature of 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 income 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 would be 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. (However, FASB ASC 235-10-50-2 does not require disclosure of accounting policies for unaudited interim financial statements unless an accounting policy has changed since the preceding fiscal year end.) 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, as discussed below.

It is a best practice to follow the GAAP guidance in presentations prepared using the cash, modified cash, or income 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 makes sense 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.

Specific Disclosures of Accounting Policies Required by GAAP

Certain GAAP pronouncements specify accounting policies that entities are required to disclose. Examples include a description of depreciation methods required by FASB ASC 360-10-50-1 and the policies with respect to trade receivables that are discussed later in this lesson. Generally, if the policies are relevant to financial statements prepared on a financial reporting framework other than generally accepted accounting principles, disclosures similar to those that would be required by GAAP should be provided.

Considerations for Cash Basis Presentations

Cash basis financial statements typically consist of a statement of cash receipts and disbursements, presenting the difference between the two as the increase or decrease in cash. To illustrate the description of that basis, assume that a trade association presents a statement of cash receipts and disbursements and that the only significant differences from GAAP are that the effects of outstanding dues and obligations for assessments are not reflected. The following disclosure would be appropriate:

The accompanying financial statement has been prepared on the cash receipts and disbursements basis of accounting. Under that basis, the only asset recognized is cash, and no liabilities are recognized. All transactions are recognized as either cash receipts or disbursements, and noncash transactions are not recognized. The cash basis differs from accounting principles generally accepted in the United States of America primarily because the effects of outstanding dues and obligations for assessments are not included in the financial statement.

Typically, only small entities with simple operations use the cash basis for their financial statements. Consequently, there may be situations in which there are no material differences between the cash basis and GAAP. In such cases, accountants have two alternatives—treat the presentation as a statement of operations under GAAP or describe the presentation as showing cash receipts and disbursements but with no significant differences from GAAP. Although characterizing the presentation as prepared using GAAP is conceptually justified, doing so should be avoided because, even with appropriate disclosure, financial statement readers likely will still question why the statement presents only cash receipts and disbursements. Using the latter alternative instead would disclose the basis of

accounting through a note such as the following: (Note that the disclosure is the same as the example in the preceding paragraph with one exception—the last sentence has been changed to state that there are no significant differences from GAAP.)

The accompanying financial statement has been prepared on the cash receipts and disbursements basis of accounting. Under that basis, the only asset recognized is cash, and no liabilities are recognized. All transactions are recognized as either cash receipts or disbursements, and noncash transactions are not recognized. There are no significant differences from accounting principles generally accepted in the United States of America.

Considerations for Modified Cash Basis Presentations

The description of the basis does not need to identify the modifications of the cash basis. Instead, the description of the primary differences from GAAP provides enough information for the financial statement reader to understand the basis. The following illustrates:

The accompanying financial statements have been prepared on the modified cash basis of accounting. That basis differs from accounting principles generally accepted in the United States of America primarily because the Company has not recognized balances, and the related effects on earnings, of accounts receivable from patients and third-party agencies and of accounts payable to vendors.

If there are no significant differences between financial results using the modified cash basis of accounting and GAAP, it is a best practice to replace the last sentence of the preceding disclosure with a sentence stating that there are no significant differences between the basis of accounting and GAAP or reporting on the financial statements as being prepared in accordance with GAAP.

Considerations for Income Tax Basis Presentations

Following the accounting principles used for income tax reporting may result in presentations of results that are the same as those on the cash basis or on the modified cash basis, accrual basis presentations with material differences from GAAP, or presentations that do not differ materially from GAAP. The description of the accounting basis can state whether the basis is the cash or accrual basis of accounting used for tax reporting. In addition, since federal requirements often differ from those for other taxing authorities, disclosing which basis is used often is helpful, such as the “accrual basis of accounting used for federal income tax reporting.” The following illustrates the description for a cash basis taxpayer:

The accompanying financial statements have been prepared on the cash basis of accounting used by the Company for federal income tax purposes. That basis differs from accounting principles generally accepted in the United States of America primarily because receipts of rent in advance are recognized immediately instead of being deferred and because expenses generally are recognized when paid instead of when the underlying obligation is incurred.

If there are no significant differences between the income tax basis of accounting and GAAP, it is a best practice to replace the last sentence of the preceding disclosure with a sentence stating that fact or reporting on the financial statements as being prepared in accordance with GAAP.

FINANCIAL STATEMENT ITEMS FOR WHICH GAAP REQUIRES DISCLOSURE

The authoritative auditing literature and the authoritative SSARS literature discussed at the beginning of this lesson indicate that if special purpose financial statements contain amounts for which GAAP would require disclosure, the financial statements should either provide the relevant disclosure that would be required for those amounts in a GAAP presentation or provide information that communicates the substance of that disclosure. Applying the authoritative guidance involves (a) identifying financial statement items for which GAAP would require disclosure; (b) deciding whether the GAAP disclosure requirement is relevant to the basis used; and (c) 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.

Identifying Financial Statement Items for Which GAAP Would Require Disclosure

GAAP prescribes a variety of disclosures for items reported in financial statements, such as the following:

- a. *Amounts.* Examples of amounts that GAAP requires disclosing either in the statements or the accompanying notes are depreciation, interest, rent, and retirement plan expense.
- b. *Components of Amounts.* For example, GAAP requires disclosing the components of property and equipment and the income tax provision.
- c. *Information about Measurement.* Typically, measurement information relates to assets measured at fair value (such as investments in marketable equity securities), assets that have been reduced below their cost (typically through a valuation allowance), or accrued losses.
- d. *Supplemental Fair Value Information.* The disclosures provide information about the fair value of financial instruments reported at cost and those for which amounts are not recorded.
- e. *Information about Transactions Related to the Item.* Examples are descriptions of leasing arrangements when rent income or expense is reported, the scheduled principal reduction of long-term obligations recorded, information about the plan when retirement plan expense is reported, and the terms of related-party transactions that lead to amounts reported in the financial statements.
- f. *Other Information about the Item.* An example is the relationship of the tax provision to pretax income.

Financial statement items for which GAAP would require disclosure can be identified by reading the financial statements looking for such items or using a disclosure checklist such as the ones provided in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*.

Assessing the GAAP Requirement's Relevance to the Basis of Accounting

If GAAP would require disclosure for an item reported in cash, modified cash, or income tax basis statements and the GAAP measurement has a counterpart in the basis of accounting used, it seems logical that the GAAP disclosure requirements generally are relevant to the cash, modified cash, or income tax basis presentation. That reasoning is applied to the categories of GAAP discussed above as follows:

- a. *Amounts.* If GAAP would require disclosure of an amount recognized by the basis of accounting, it is a best practice to also disclose that amount in the cash, modified cash, or income tax basis financial statements. For example, the GAAP requirement to disclose depreciation expense is relevant to a tax basis presentation of an entity that has depreciable assets because the tax basis financial statements would report depreciation. Alternatively, for example, the GAAP requirement to disclose depreciation expense is not relevant to a pure cash basis presentation, which only reports transactions that affect cash and cash equivalents. Reporting depreciation expense, however, is a common modification found in modified cash basis presentations and in that situation disclosure of the depreciation expense policy is expected.

- b. *Components of Amounts.* If GAAP would require disclosing the components of an amount recorded in the financial statements, it is logical for the components to also be disclosed in cash, modified cash, or income tax basis statements. For example, the components of rental or other property and equipment should be disclosed in tax basis statements or in modified cash basis statements that capitalize property and equipment. However, the GAAP requirement to disclose the components of income taxes is not relevant if deferred taxes are not measured (such as in a cash basis presentation) or are not applicable (such as in an income tax basis presentation).
- c. *Information about Measurement.* Whether the GAAP requirement is relevant depends on whether it relates to the same measurement as in the cash, modified cash, or income tax basis presentation. For example, the requirement to disclose information about unrealized gains and losses in investments in marketable equity securities is not relevant to a tax basis presentation that measures the investments at their cost. Similarly, requirements to provide information about asset valuation allowances are not relevant to tax basis presentations that only recognize losses when they are realized. (Disclosure about potential losses may be necessary to keep the financial statements from being misleading, however.)
- d. *Supplemental Fair Value Information.* GAAP only requires nonpublic entities to disclose information about the fair value of financial instruments if they have total assets of at least \$100 million on the date of the financial statements or have a financial instrument that, in whole or in part, is accounted for as a derivative instrument during the reporting period. If GAAP would not require the entity to disclose such information in GAAP financial statements, it also seems unnecessary in cash, modified cash, or income tax basis presentations. Otherwise, this course suggests the following:
 - (1) GAAP requirements to provide supplemental fair value information about recorded amounts are relevant to cash, modified cash, and income tax basis presentations. For example, information about the fair value of investments in marketable equity securities recorded at their cost is relevant to tax basis statements. However, while the fair value information that would be required by FASB ASC 825-10-50-10, *Financial Instruments*, is relevant, the fair value information that would be required by FASB ASC 320-10-50, *Investments—Debt and Equity Securities*, is not relevant since it assumes the investments are measured at fair value.
 - (2) GAAP requirements to provide fair value information about financial instruments for which amounts are not recorded are only relevant in financial statements prepared on an accrual basis of accounting, such as that used for federal income tax reporting. The readers of financial statements prepared with a cash orientation likely do not expect to see information about unrecorded financial instruments. For example, the reader of a cash basis presentation generally would not expect to see fair value information about a foreign currency option.

FASB ASC 825-10-50-16 permits not providing fair value information for a financial instrument for which estimating the information is not practicable (that is, if estimating the information is excessive for the benefits it would provide). Since FASB ASC 825-10-50-17 notes that practicability is a “dynamic concept,” the determination of whether the cost of estimating fair value information is excessive, and hence not practicable, may vary depending on the basis of accounting used. For example, users who accept tax basis financial statements may find fair value information less critical than users who request GAAP financial statements. Thus, the threshold for determining whether the costs of developing the fair value information are excessive might be lower in tax basis financial statements.

- e. *Information about Transactions Related to the Item.* Such requirements generally seem relevant to cash, modified cash, and income tax basis presentations, but alternate ways often may be used to communicate the substance of the requirements.
- f. *Other Information about the Item.* Generally, whether other information about the item is relevant depends on the basis of accounting. For example, since the reader of cash basis statements should not expect the relationship of income taxes and pretax income to be predictable, the GAAP requirement to disclose the primary reasons for the variance in the relationship is not relevant. On the other hand, even though the amount of rent expense recorded may differ depending on the basis of accounting, the notes to the financial statements should include disclosure of commitments related to long-term lease agreements.

Considerations for Derivatives. FASB ASC 815, *Derivatives and Hedging*, provides measurement and disclosure requirements for derivative instruments (often referred to simply as derivatives) and hedging activities. Under the guidance provided by FASB ASC 815-10-15-83 through 15-139, all derivatives are contracts, but not all derivatives are financial instruments. All derivatives are required to be measured at their fair value. The accounting for changes in fair value in GAAP financial statements generally varies depending on the purpose for which the entity entered into the derivative. For example, changes in the fair value of derivatives entered into as investments are reported in earnings, but changes in the fair value of derivatives entered into as hedges of risks may be reported in earnings or other comprehensive income, generally depending on the accounting requirements for the hedge. The disclosure requirements of FASB ASC 815 are consistent with, but more extensive than, those of FASB ASC 825-10-50-10 for financial instruments.

The requirements of FASB ASC 815 raise questions about the accounting for derivatives in cash, modified cash, and income tax basis statements. For example, should—

- Derivatives be adjusted to their fair value? If so, how should changes in fair value be presented?
- Disclosures be provided following the requirements of FASB ASC 825-10-50-10 and FASB ASC 815?

As a practical matter, entities with significant derivative transactions do not seem likely to issue cash or modified cash basis statements for third-party reporting purposes. In the unusual situation in which such an entity issues income tax basis statements, there may not be anything recorded in those statements related to the transactions (such as for certain interest rate swaps). In the event that derivative transactions are recorded in the income tax basis financial statements, the following may apply—

- a. Measuring derivatives at their tax bases typically will not result in adjusting them to their fair value.
- b. Following the guidance in item d. above, estimating the fair value of derivatives may not be practicable.
- c. The general disclosure requirements of FASB ASC 815, that do not relate to the measurement of derivatives at fair value will often be relevant, such as the objectives for holding derivatives, the context needed to understand those objectives, and the entity's strategies for achieving those objectives.

Exploring Alternative Ways to Communicate the Substance of the GAAP Requirement

Whether alternative ways to communicate the substance of the GAAP requirement should be explored usually depends on whether GAAP would require disclosing amounts, such as future cash receipts or disbursements either to reduce long-term obligations or in connection with long-term leases. In any event, it is a good idea to explore alternative ways only if doing so might create efficiencies. For example, an entity that has several significant debt obligations may find that calculating and disclosing the amounts of debt principal reduction over each of the next five years may be more efficient than exploring alternative ways to disclose that information. Alternative ways of communicating the substance of GAAP disclosure requirements may create efficiencies if the answer to any of the following questions is yes:

- a. *Does the Description of the Terms of the Underlying Transactions Already Provide Enough Information?* That may be the case when GAAP requires information about the item's effect on future cash flows. For example, if the entity has only one or two significant long-term obligations, each of which is payable in installments of level principal reduction plus interest, disclosing the repayment terms and the remaining loan period may provide financial statement readers with enough information to understand cash required for future debt reduction. (On the other hand, if an entity has several significant debt obligations, merely disclosing the repayment terms and the remaining loan period may not be sufficient since readers would not be able to determine the effects of future debt reductions without substantial additional effort.)

- b. *Can Significance Be Described Using Adjectives, Ratios, or Percentages Instead of Quantities?* That may be the case when GAAP requires disclosing information about the source of amounts. For example, instead of disclosing the amount of related-party sales, their significance might be communicated through a percentage, such as “approximately 30%,” a ratio, such as “approximately a third,” or through adjectives, such as “substantially all.”
- c. *Can Significance Be Described in Relation to Another Financial Statement Amount?* For example, instead of disclosing amounts, the impact of contingent rent on operations might be communicated as a percentage, or range of percentages, of minimum rentals. Similarly, instead of disclosing the amount of uninsured cash balances, a note might say that the risk from concentrating cash credit risk “typically averages between \$50,000 and \$100,000” or, if substantially all cash is deposited in an uninsured investment deposit account, that the risk “approximates the balances reported in the accompanying financial statements.”

Considerations for Trade Receivables. The following paragraphs only address application of FASB ASC 310-10-50, *Receivables*, to the short-term unsecured customer financing that results in the recognition of trade receivables since that is the most common financing activity of entities that issue special purpose financial statements. *PPC's Guide to Preparing Financial Statements* provides a more thorough discussion.

Disclosure Considerations in Pure Cash Basis Financial Statements. It seems likely that the disclosure requirements are not relevant to financial statements prepared on the pure cash basis of accounting because the use of that basis does not result in the recognition of trade receivables.

Disclosure Considerations in Modified Cash Basis Financial Statements. As previously discussed, recognizing trade receivables seems inconsistent with the cash orientation portrayed by the modified cash basis. Accordingly, the disclosure requirements are not relevant to those financial statements.

Disclosure Considerations in Income Tax Basis Financial Statements. In contrast to financial statements prepared using the modified cash basis, income tax basis statements might recognize trade receivables. The substance of the disclosure requirements related to accounting for trade receivables and collection losses could be communicated through the basis of accounting note or through a separate policy note.

The following is an example of a basis of accounting note designed to appropriately communicate the substance of the required information about accounting policies:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The accompanying financial statements have been prepared on the accrual basis of accounting used by the entity for federal income tax purposes. This basis differs from accounting principles generally accepted in the United States of America primarily because amounts due under trade accounts are reported at the amount outstanding rather than at their estimated net realizable value. Charges to earnings for uncollectible balances are recognized when management has exhausted all reasonable collection efforts.

The following is an example of a separate policy note designed to appropriately communicate the substance of the required information about accounting policies:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Trade Receivables

Trade receivables are reported at the amount of principal outstanding. Balances are written off through charges to earnings only after management has exhausted reasonable collection efforts and concluded that additional collection efforts are not cost-effective.

The only type of trade 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 trade 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 trade receivables, 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 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.

Considerations for Guarantees of Debt. FASB ASC 460-10, *Guarantees*, requires guarantors to record certain guarantees of debt of other parties at their fair value and disclose certain information about their guarantees of debt. Entities that issue special purpose financial statements rarely guarantee debt of other parties that are not related parties, and those types of guarantees are excluded from the measurement requirements of the guidance. Therefore, for example, an entity that guarantees the debt of another member of a controlled group would not be required to record the guarantee. FASB ASC 460-10-50-4 requires disclosure of all guarantees in a guarantor's financial statements. For guarantees of debt of related parties, FASB ASC 460-10-50-4 generally requires disclosure of the nature of the guarantee and the maximum undiscounted amount of payments the entity could be required to make. Those same disclosures should also be provided in special purpose financial statements.

OTHER INFORMATION FOR WHICH GAAP REQUIRES DISCLOSURE

GAAP requires entities to disclose a variety of information that does not relate directly to items reported in GAAP financial statements, such as the following:

- Going concern considerations.
- Related-party transactions for which amounts are not recorded.
- Commitments and contingencies.
- Impairment of assets.
- Subsequent events.
- Risks and uncertainties.
- Uncertainty in tax positions.
- Arrangements with variable interest entities.

It is a best practice to evaluate the need for similar disclosures in cash, modified cash, and income tax basis financial statements following an approach similar to the one discussed earlier in this lesson. That is, entities should—

- a. identify the other information that GAAP would require disclosing, for example, by using a disclosure checklist. (Often, the GAAP requirement is presented along with guidance for recorded amounts. For example, FASB ASC 850-10-50, *Related Party Disclosures*, requires disclosures about related-party transactions for which amounts have been recorded in the financial statements and for those transactions for which no amounts have been recorded. Similarly, FASB ASC 825-10-50-10, *Financial Instruments*, if applicable, requires disclosing fair value information for financial instruments regardless of whether an amount has been recorded for them in the financial statements.)
- b. decide whether the GAAP disclosure requirement is relevant to the basis of accounting. (For example, the requirement to point out the general use of estimates would not be relevant to a pure cash basis presentation or to a tax basis presentation that has no estimates.)
- c. if the requirement is relevant, decide whether to follow that requirement or to meet the objective of that requirement through other means. (Generally, that decision should be made based on efficiency. As a practical matter, unless GAAP would require disclosure of quantitative information, it is a best practice not to consider alternatives.)

Risks and Uncertainties

FASB ASC 275-10-50-1, *Risks and Uncertainties*, offers a variety of disclosure considerations to illustrate how to apply the guidance in the preceding paragraph. GAAP requires providing information about the following four areas:

- a. *Nature of Operations.* The disclosure provides key operating information to help the financial statement reader better understand the operations. It seems relevant to all cash, modified cash, and income tax basis presentations. Providing the necessary information typically takes little time and requires few changes in subsequent financial statements.
- b. *Use of Estimates.* Whether the information is relevant depends on whether the accounting basis uses estimates. While it is not relevant to the pure cash basis, it may be relevant to the modified cash basis, such as when useful lives are estimated for depreciation calculations. The requirement also may be relevant to the income tax basis, such as when estimated direct costs are used to calculate the percentage of completion of contracts.
- c. *Certain Significant Estimates.* The requirement to disclose certain significant estimates is designed to alert financial statement readers to the reasonable possibility that an estimated amount in the current year's statements will change with a material effect on next year's statements. It seems relevant to modified cash and tax basis statements that have estimates, but it is not relevant to pure cash basis statements as they have no estimates.

Some items that require estimates in GAAP financial statements, such as collectibility of amounts due from customers, do not require estimates in income tax basis statements. Although the requirement does not apply to those amounts, if a material loss is likely on realization of an asset recorded in the financial statements or on settlement of a recorded liability, disclosure of that likelihood may be necessary to keep the statements from being misleading, similar to the discussion in FASB ASC 450-20-50-9 about disclosure of loss contingencies.

- d. *Significant Concentrations of Risk.* The requirement is intended to notify financial statement readers of the reasonable possibility that the loss of a significant customer, supplier, or other concentration will have a severe impact on the entity. The information seems relevant to all cash, modified cash, and income tax basis presentations. For example, the reasonable possibility that the loss of the source of a significant portion of the recorded cash receipts will have a severe impact is relevant to the readers of a cash basis presentation. As a practical matter, management normally knows whether there are concentrations with

such a risk, and the necessary information can be gathered through inquiry. In addition, there is no requirement to quantify the effect. Instead, the significance of the concentration can be conveyed using estimated percentages, such as “approximately 60%,” a ratio, such as “approximately half,” or adjectives, such as “most.”

Going Concern Uncertainty

GAAP Requirements. FASB ASC 205-40 addresses going concern and establishes that the evaluation of an entity's ability to continue as a going concern is *management's* responsibility. In addition, it establishes when management is required to disclose certain matters related to going concern. The requirements in FASB ASC 205-40 are effective for annual periods ending after December 15, 2016.

For each reporting period, FASB ASC 205-40-50-1 requires management to evaluate whether conditions or events indicate there is substantial doubt about the entity's ability to continue as a going concern for the year subsequent to the date the *financial statements are issued* or the date the *financial statements are available to be issued*. Special purpose frameworks may not include an explicit requirement for management to evaluate the entity's ability to continue as a going concern for a reasonable period of time, as further discussed later in this lesson.

The terms *financial statements are issued* and *financial statements are available to be issued* are defined in FASB ASC 205-40-20. Substantial doubt about an entity's ability to continue as a going concern exists when aggregate conditions and events indicate it is *probable* that the entity will not be able to meet its obligations as they are due during the year following the date the financial statements are available to be issued. The guidance, in defining substantial doubt, uses the term *probable*, which means likely to occur.

If conditions and events that raise doubt about an entity's ability to continue as a going concern exist, management would consider mitigating plans and whether those plans alleviate the substantial doubt. Management's plans may be considered to alleviate the substantial doubt if it is probable the plans (a) will be implemented effectively within one year of the date the financial statements are available to be issued *and* (b) mitigate the conditions and events that raised substantial doubt.

Disclosure. Certain disclosures are required depending on whether management's plans alleviate the substantial doubt. The disclosures are required for all periods that the substantial doubt about the entity's ability to continue as a going concern remains. The disclosures should provide further explanations as more information becomes available.

Reporting Responsibilities. When a going concern uncertainty exists, the practitioner should consider both the need for report modification, if the financial statement disclosures are not adequate, and an emphasis-of-matter paragraph.

Going Concern Uncertainty and Special Purpose Frameworks. As mentioned above, GAAP requires management to evaluate whether conditions and events indicate there is a substantial doubt about the entity's ability to continue as a going concern for a specified timeframe. However, special purpose frameworks are not GAAP, and such frameworks may not include an explicit requirement for management to evaluate the entity's ability to continue as a going concern for a reasonable period of time. An auditor's responsibility in this situation is addressed by SAS No. 132, as discussed below. Lack of a specific requirement for management to assess going concern under a special purpose framework is also discussed in the SSARS. According to AR-C 90.65, when the entity uses a financial reporting framework that does not specify a forward-looking time period for management to consider any going concern issue, then a reasonable period of time is one year from the date the financial statements were reviewed. This period also seems appropriate for prepared or compiled financial statements.

Recent AICPA Going Concern Activities. The following paragraphs discuss recent activities by the AICPA in the area of going concern uncertainty that affect audit and review engagements.

Audit Engagements. In February 2017, the Auditing Standards Board (ASB) issued SAS No. 132 (AU-C 570), *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, which supersedes, when effective, the current guidance at SAS No. 126 (AU-C 570A). Conceptually, the primary difference between SAS No. 132 and the existing guidance is that the new standard explicitly recognizes management's responsibility to consider going

concern issues under GAAP and premises the auditor's procedures on that responsibility. It also clarifies the applicability of the standard when the financial statements are based on a financial reporting framework other than GAAP.

While SAS No. 132 is effective for audits of financial statements for periods ending on or after December 15, 2017, because SAS No. 132 incorporates management's evaluation of whether aggregate conditions or events exist that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, it seems likely that certain of the requirements would be performed prior to its effective date.

One of the primary technical differences between existing guidance in SAS No. 126 and SAS No. 132 is the lookout period, or *reasonable period of time*. Under SAS No. 132, *reasonable period of time* is defined as the period required by the applicable financial reporting framework, or, if no such period is designated, one year from the date the financial statements are available to be issued. This brings the lookout period under the auditing standards into line with the period defined by GAAP in FASB ASC 205-40.

Additionally, SAS No. 132 amended AU-C 800.12 (including adding application guidance at AU-C 800.A14) to note that regardless of whether the going concern basis of accounting is relevant to the special purpose financial statements, the requirements in AU-C 570.03 apply regarding (a) the conclusion on whether substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time and (b) the evaluation of the financial statement effects, as well as the adequacy of related disclosures, regarding going concern matters. Accordingly, the auditor is not relieved of his or her responsibility to consider whether the going concern basis of accounting applies to the financial statements when the reporting framework is a special purpose framework.

Review Engagements. The Accounting and Review Services Committee (ARSC) of the AICPA is currently working on a going concern project and has drafted a proposed exposure draft that will address going concern in a review engagement. It is anticipated that the exposure draft, which will include more than going concern, will be issued in September 2017 with comments due by the end of the year.

In the August 2017 meeting of the ARSC, it was decided that revisions should be made to AR-C 90 to substantially harmonize the requirements in a review engagement related to the accountant's consideration of an entity's ability to continue as a going concern with those resulting from the issuance of SAS No. 132. The upcoming exposure draft is expected to do the following:

- Require the accountant to make additional inquiries of management with respect to going concern considerations.
- Add a management representation regarding full disclosure of information relevant to the going concern assumption in the financial statements.
- Require the accountant to perform certain review procedures related to going concern when the applicable financial reporting framework includes requirements for management to evaluate the entity's ability to continue as a going concern for a reasonable period of time. (This requirement would address going concern for entities using GAAP as their financial reporting framework.)
- Require the accountant to perform certain review procedures related to going concern when the applicable financial reporting framework does not include a requirement for management to evaluate the entity's ability to continue as a going concern for a reasonable period of time. In this situation, a reasonable period of time would be within one year after the date the financial statements are issued (or available to be issued). (This requirement would address going concern for entities using a special purpose framework as their financial reporting framework.)
- Require the accountant to include an emphasis-of-matter paragraph in the accountant's review report related to going concern in specified circumstances, regardless of whether the entity is using a financial reporting framework that requires a note to the financial statements that substantial doubt exists. (Thus, such an emphasis-of-matter paragraph would be required for review reports under special purpose frameworks, as well as GAAP.)

The proposed SSARS is anticipated to be effective for reviews of financial statements for periods on or after June 15, 2019. A future edition of this course will provide further information on this project and the proposed SSARS.

Going Concern Considerations for Special Purpose Framework Financial Statements. Conditions indicating substantial doubt about the entity's ability to continue as a going concern may not be as evident in pure cash and modified cash basis financial statements as they are in financial statements prepared using generally accepted accounting principles. For example, a statement of cash receipts and disbursements prepared under the pure cash basis may reflect an increase in cash even though the entity has suffered recurring losses. Similarly, if an entity preparing modified cash basis financial statements does not accrue expenses, working capital deficiencies and adverse financial ratios may not be as readily apparent as in a presentation prepared using GAAP. As another example, if the entity does not modify the financial statements to reflect depreciation, the financial results presented in the statement of revenues and expenses might look significantly better than they would under a GAAP presentation.

Conditions indicating substantial doubt about the entity's ability to continue as a going concern may also not be as evident in income tax basis financial statements as they are in financial statements prepared using generally accepted accounting principles. For example, since a cash basis taxpayer does not accrue expenses, working capital deficiencies and adverse financial ratios may not be as readily apparent as in a presentation prepared using GAAP. Similarly, results under the accrual basis used for income tax reporting will often look better than under generally accepted accounting principles, for example, because GAAP would recognize losses before they are deductible for tax purposes or because advance payments are taxable before they are recognized as revenues under GAAP. On the other hand, results under the accrual basis used for income tax reporting could look worse than under generally accepted accounting principles, for example, because the use of accelerated depreciation methods for income tax basis financial statements instead of the straight-line method initially results in losses and retained earnings deficits.

Financial results, including the impact of the basis of accounting on those results, should be considered when determining whether there is substantial doubt about the entity's ability to continue as a going concern. Financial results are just one indicator of a going concern uncertainty, however. Many other conditions could indicate going concern uncertainty. For example:

- *Other Financial Indicators.* Other financial indicators of going concern uncertainty include a default on loan agreements, denial of usual trade credit from suppliers, and the disposal of substantial assets.
- *Internal Matters.* Internal matters that could be indicators of going concern uncertainty include work stoppages or other labor difficulties, substantial dependence on the success of a particular project, and the need to significantly revise operations.
- *External Matters.* External matters that could be indicators of going concern uncertainty include legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to operate; losing a principal customer or supplier; and an uninsured or underinsured catastrophe such as a drought, earthquake, or flood.

Because the presence of the preceding conditions or events is not impacted by whether the financial statements are presented using a special purpose framework or using generally accepted accounting principles, it would likely be rare for the preparation of financial statements using the pure cash, modified cash, or income tax basis of accounting rather than GAAP to affect an accountant's conclusion about an entity's ability to continue as a going concern.

The following illustrative disclosure addresses the situation when management has taken steps to alleviate the substantial doubt:

Substantial Doubt Alleviated

As shown in the accompanying financial statements, the Company incurred a net loss of \$1,275,000 during the year ended December 31, 20X6, and as of that date, the Company's current liabilities exceeded its current assets by \$327,000 and its total liabilities exceeded its total assets by \$2,272,000. Those factors, as well as the uncertain conditions that the Company faces regarding its loan agreements (as discussed in Note B), create uncertainty about the Company's ability to continue as a going concern. Management of the Company has evaluated these conditions and determined that a reduction of liabilities would alleviate this uncertainty. As a result, management has received approval from its bank creditors and is implementing its plan to reduce its liabilities through the sale of assets and issuance of additional stock to shareholders. The Company has contracted with a broker to sell the Company's vacant real property, and in the broker's opinion, a contract should be in place within six to nine months. As discussed in Note F, additional stock in the amount of \$500,000 was issued to existing shareholders in March of 20X7.

Subsequent Events

The authoritative literature on accounting for subsequent events that is in FASB ASC 855-10, *Subsequent Events*, provides guidance on two types of subsequent events. (See FASB ASC 855-10-25-1 to 25-3.)

- a. The first type, referred to as *recognized subsequent events*, provides additional information about whether an asset was impaired or a liability was incurred at the end of the reporting period. This information should be considered in determining the carrying amount of the asset or liability at the end of the reporting period.
- b. The second type, referred to as *nonrecognized subsequent events*, provides information that does not indicate that an asset was impaired or a liability was incurred at the end of the reporting period (because the subsequent event occurred after the end of the reporting period) but may require disclosure so the financial statements will not be misleading.

To illustrate how to apply the guidance in financial statements prepared using generally accepted accounting principles, assume that at year-end the reporting entity has a significant amount due under a trade account with a major customer that is having financial difficulties. Subsequent to year-end, the customer incurs a substantial uninsured loss. That information should be considered in determining whether a loss should be recognized for impairment of the principal outstanding under the account at year-end.

Now change the illustration so that the customer was not having financial difficulties at year-end. Although the principal outstanding under the trade account was not impaired at year-end, it may be necessary to disclose the subsequent uninsured loss in order to keep the financial statements from being misleading.

FASB ASC 855-10-50 requires disclosure of the following:

- a. The date through which subsequent events have been evaluated by the reporting entity's management and whether that date is the date the financial statements were issued or the date the financial statements were available to be issued. Generally, the date will be the date that the financial statements were available to be issued for nonpublic entities. Note that this disclosure is required regardless of whether an actual subsequent event occurred.
- b. The nature of, an estimate of the financial statement effect of, or a statement that such an estimate cannot be made for subsequent events that are of such a nature that they must be disclosed to keep the financial statements from being misleading (nonrecognized subsequent events).

Q&A 1500.07, *Disclosure Concerning Subsequent Events in Special Purpose Financial Statements*, clarifies that these disclosures should be made in financial statements prepared on the pure cash, modified cash, or income tax basis of accounting.

FASB ASC 855-10-50-3 also notes that an entity should consider supplementing the historical financial statements with pro forma data or presenting pro forma financial statements if a nonrecognized subsequent event is so significant that disclosure is best made by means of such pro forma financial data.

FASB ASC 855-10-50-4 requires an entity to disclose the date through which subsequent events have been evaluated in both originally issued financial statements and reissued financial statements, if any. It is a best practice to also make this disclosure in financial statements prepared on the pure cash, modified cash, or income tax basis of accounting.

AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, discusses the types of subsequent events that should be evaluated in an audit and specifies the procedures that should be performed to determine the occurrence of such events. AR-C 90.22f and AR-C 90.69–.70 specify procedures that should be performed by the accountant related to subsequent events during the performance of a review. During the performance of a compilation engagement, if the accountant becomes aware of subsequent events that may cause the financial statements to be misleading because they are not properly reflected, AR-C 80.15 requires the accountant to discuss revising the financial statements with management.

Subsequent Events Considerations in Income Tax Basis Financial Statements. Whether subsequent events should be considered in measuring assets and liabilities in income tax basis financial statements depends on tax positions the entity takes in its income tax returns. For example, subsequent events would be considered in determining whether a liability should be recognized for expenses deducted under the recurring item exception. To illustrate, assume that an entity offers its customers a warranty and deducts warranty costs following the recurring item exception. Subsequent payments through the period covered by the exception would be considered in measuring the liability for warranty costs at year-end, but other subsequent warranty payments would not be considered.

If disclosure of subsequent events is necessary to keep the financial statements from being misleading, the financial statements should either disclose the information that would be required under generally accepted accounting principles or disclose information that communicates the substance of those requirements. For example, disclosure of a subsequent further deterioration of the financial condition of a major customer may be necessary to keep the financial statements from being misleading even if management has not yet determined whether the principal outstanding under the customer's trade account at year-end is worthless. As an observation, the subsequent further deterioration would not be considered in measuring the trade account at year-end because any write-off would only be deductible in the period the account becomes worthless.

Subsequent Events Considerations in Pure Cash and Modified Cash Basis Financial Statements. Since the pure cash basis only recognizes one asset—cash—and it recognizes no liabilities, subsequent events cannot affect the measurements in pure cash basis financial statements. Since modifications of the pure cash basis should generally conform with selected generally accepted accounting principles, subsequent events should be considered in measuring the assets and liabilities recognized through those modifications.

If disclosure of subsequent events is necessary to keep pure cash or modified cash basis financial statements from being misleading, the financial statements should either disclose the information that would be required under generally accepted accounting principles or disclose information that communicates the substance of those requirements. For example, disclosure of a subsequent event that indicates a material balance due from a customer at year-end is impaired may be necessary to keep the financial statements from being misleading even though customer receivables are not recognized under the modifications of the pure cash basis.

Illustrative Disclosure. An example subsequent events disclosure follows:

NOTE X—SUBSEQUENT EVENT

Events subsequent to December 31, 20X7, have been evaluated through March 18, 20X8, the date these financial statements were available to be issued, to determine whether they should be disclosed to keep the financial statements from being misleading. Under an agreement effective February 16, 20X8, a partnership in which the Company has an interest was relieved of future rights in a real estate joint venture. Substantially all of the Company's investment in the

partnership, totaling approximately \$76,000 at December 31, 20X7, will be deemed worthless for federal income tax purposes during 20X8. Management found no other subsequent events that should be disclosed.

SELF-STUDY QUIZ

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

7. Whammy Inc. presents its financial statements using the cash basis. If it does not want to make a GAAP disclosure about the disposal of a component, how could it proceed?
 - a. It can present the disposal in a separate column.
 - b. It can present expenses using the natural classifications from its Form 990.
 - c. It can present the information in the notes to the financial statements.
 - d. It can present only one basic financial statement.
8. Fairview Exchanges (FE) includes a summary of significant accounting policies as one of its financial statement notes. This note says that FE used the basis of cash receipts and disbursements with some assets and liabilities recorded. What basis of accounting does FE use?
 - a. The cash basis.
 - b. The contractual basis.
 - c. The income tax basis.
 - d. The modified cash basis.
9. Pickletown presents its financial statements using the income tax basis of accounting. Pickletown has depreciable assets and it measures its investments at their cost. The business is nonpublic and has total assets of \$5 million. Which of the following does Pickletown need to disclose?
 - a. Depreciation amounts.
 - b. The components of income taxes.
 - c. Information about unrealized gains/losses in marketable securities.
 - d. Information about the fair value of financial instruments.
10. Generally, what factor holds the most weight when determining if a relevant GAAP disclosure is needed in special purpose financial statements?
 - a. Whether it is mandatory GAAP.
 - b. Whether making the disclosure is efficient.
 - c. Whether the statements are understandable without it.
 - d. Whether it is related to a subsequent event.

11. GAAP requires financial statements to provide information about risks and uncertainties. Which of these disclosures will affect pure cash, modified cash, and income tax basis financial statements?
- a. Use of estimates.
 - b. Nature of operations.
 - c. Certain significant estimates.
 - d. Lack of concentrations.
12. How are considerations about the entity's ability to continue as a going concern treated in special purpose frameworks?
- a. If the special purpose framework does not require the consideration, the entity is exempt from it.
 - b. A going concern issue is not considered to exist unless the situation will definitely occur.
 - c. Consideration of the entity's ability to continue as a going concern must be assessed at least once a year.
 - d. Whether or not there is substantial doubt, management must have a mitigating plan available.
13. Which of the following entities is most likely to have a going concern issue?
- a. EMK Company has positive financial results.
 - b. JEB Company pays off a longstanding loan.
 - c. AGP Company is undergoing legal proceedings.
 - d. MMZ Company recently signed a new labor contract.
14. Which of the following statements best describes *nonrecognized subsequent events*?
- a. They occurred after the end of the reporting period.
 - b. They are used when determining the carrying amount at the end of the period.
 - c. They are considered pro forma data.
 - d. They do not affect financial statements prepared using a special purpose framework.

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.)**

7. Whammy Inc. presents its financial statements using the cash basis. If it does not want to make a GAAP disclosure about the disposal of a component, how could it proceed? **(Page 131)**
- a. **It can present the disposal in a separate column. [This answer is correct. Whammy Inc. can communicate the objective of the GAAP requirements, which is to separate the effects of this item because of its effect on the comparability of the financial statements. One method for doing so would be to present the results of a disposed component of an entity in a separate column of a cash basis presentation.]**
 - b. It can present expenses using the natural classifications from its Form 990. [This answer is incorrect. Nonprofit organizations file Form 990. This type of presentation would help a nonprofit organization using the income tax basis of accounting. Neither of those qualifications apply to Whammy Inc. in this scenario.]
 - c. It can present the information in the notes to the financial statements. [This answer is incorrect. This presentation would work for unusual or infrequent items, but there is a better method for dealing with the disposal of a component described in this scenario.]
 - d. It can present only one basic financial statement. [This answer is incorrect. Accountants are sometimes asked to present only one basic financial statement, for example, a statement of assets, liabilities, and equity without a statement of revenues, expenses, and retained earnings. However, this is a different consideration and does not apply to the scenario described above.]
8. Fairview Exchanges (FE) includes a summary of significant accounting policies as one of its financial statement notes. This note says that FE used the basis of cash receipts and disbursements with some assets and liabilities recorded. What basis of accounting does FE use? **(Page 135)**
- a. The cash basis. [This answer is incorrect. A description of this basis of accounting would say “the basis of cash receipts and disbursements.”]
 - b. The contractual basis. [This answer is incorrect. A description of the contractual basis in such a note would read “the basis of accounting used to comply with the financial reporting provisions of Section X of this contract.”]
 - c. The income tax basis. [This answer is incorrect. An example of how the income tax basis would be described in such a note is “the basis of accounting used for federal income tax reporting” or “the accrual basis of accounting for income tax purposes.”]
 - d. **The modified cash basis. [This answer is correct. According to FASB ASC 235-10-50, AU-C 800, and the SSARS, special purpose financial statements like those presented by FE in this scenario should include the basis of accounting used to prepare the financial statements and the primary differences between the basis of accounting used and GAAP. Example descriptions that FE could use for the modified cash basis include “the basis of cash receipts and disbursements, with some assets and liabilities recorded” or, simply, “the modified cash basis.”]**

9. Pickletown presents its financial statements using the income tax basis of accounting. Pickletown has depreciable assets and it measures its investments at their cost. The business is nonpublic and has total assets of \$5 million. Which of the following does Pickletown need to disclose? **(Page 138)**
- a. **Depreciation amounts.** [This answer is correct. If GAAP would require disclosure of an amount recognized by the basis of accounting, it is a best practice to also disclose that amount in the cash, modified cash, or income tax basis financial statements. For example, the GAAP requirement to disclose depreciation expense is relevant to a tax basis presentation of an entity that has depreciable assets, like Pickletown, because the tax basis financial statements would report depreciation.]
 - b. The components of income taxes. [This answer is incorrect. If GAAP would require disclosing the components of an amount recorded in the financial statements, it is logical for the components to also be disclosed in cash, modified cash, or income tax basis statements. However, the GAAP requirement to disclose the components of income taxes is not relevant if deferred taxes are not measured (such as in a cash basis presentation) or are not applicable (such as in an income tax basis presentation like Pickletown's).]
 - c. Information about unrealized gains/losses in marketable securities. [This answer is incorrect. Whether the GAAP requirement to disclose information about measurement is relevant depends on whether it relates to the same measurement as in the cash, modified cash, or income tax basis presentation. For example, the requirement to disclose information about unrealized gains and losses in investments in marketable equity securities is not relevant to a tax basis presentation that measures the investments at cost, like Pickletown does.]
 - d. Information about the fair value of financial instruments. [This answer is incorrect. GAAP only requires nonpublic entities to disclose information about the fair value of financial instruments if they have total assets of at least \$100 million on the date of the financial statements or have a financial instrument that, in whole or in part, is accounted for as a derivative instrument during the reporting period. If GAAP would not require the entity to disclose such information in the GAAP financial statements, it also seems to be unnecessary in cash, modified cash, or income tax basis presentations. Therefore, Pickletown would not need to make this disclosure.]
10. Generally, what factor holds the most weight when determining if a relevant GAAP disclosure is needed in special purpose financial statements? **(Page 143)**
- a. Whether it is required by GAAP. [This answer is incorrect. The first step for determining whether special purpose financial statements need a GAAP disclosure is to identify the other information that GAAP would require disclosing, for example, by using a disclosure checklist. However, other considerations are necessary before disclosing the information in the special purpose statements, so merely being required by GAAP is not the final test.]
 - b. **Whether making the disclosure is efficient.** [This answer is correct. If a disclosure is required by GAAP and relevant to the special purpose financial statements, it must be decided whether to follow that requirement or to meet the objective of that requirement through other means. Generally, that decision should be made based on efficiency.]
 - c. Whether the statements are understandable without it. [This answer is incorrect. Some GAAP disclosures are not relevant to special purpose financial statements. For example, the requirement to point out the general use of estimates would not be relevant to a pure cash basis presentation or to a tax basis presentation that has no estimates. However, if the disclosure is relevant, as described above, it needs to be dealt with whether or not the statements would make sense without it.]
 - d. Whether it is related to a subsequent event. [This answer is incorrect. FASB ASC 855-10-50 requires certain disclosure for subsequent events; however, this is a separate consideration than the one discussed in this question. Subsequent events are not a factor when determining whether or not to make relevant GAAP disclosures.]

11. GAAP requires financial statements to provide information about risks and uncertainties. Which of these disclosures will affect pure cash, modified cash, and income tax basis financial statements? **(Page 143)**
- a. Use of estimates. [This answer is incorrect. This disclosure is not relevant to pure cash basis statements, but it might be relevant to modified basis statements and income tax basis statements.]
 - b. Nature of operations. [This answer is correct. This disclosure provides key operating information to help the financial statement reader better understand the operations. It seems relevant to all cash, modified cash, and income tax basis presentations. Providing the necessary information typically takes little time and requires few changes in subsequent financial statements.]**
 - c. Certain significant estimates. [This answer is incorrect. This disclosure would be relevant to modified cash basis and tax basis statements that have estimates, but it is not relevant to pure cash basis statements as they have no estimates.]
 - d. Lack of concentrations. [This answer is incorrect. FASB ASC 271-10-50-1 requires GAAP financial statements to disclose certain concentrations of risk, which also seems relevant to all cash, modified cash, and tax basis statements. However, the disclosure is required for significant risk concentrations, not a lack thereof.]
12. How are considerations about the entity's ability to continue as a going concern treated in special purpose frameworks? **(Page 144)**
- a. If the special purpose framework does not require the consideration, the entity is exempt from it. [This answer is incorrect. GAAP requires an evaluation of whether conditions and events indicate there is a substantial doubt about the entity's ability to continue as a going concern for a specified timeframe. However, special purpose frameworks are not GAAP, and such frameworks may not include an explicit requirement for this evaluation to occur. However, that does not mean the entity is exempt from this evaluation. Management and practitioners should consult SAS No. 132 and the SSARS for information on how to proceed with this evaluation under such circumstances.]
 - b. A going concern issue is not considered to exist unless the situation will definitely occur. [This answer is incorrect. Substantial doubt about an entity's ability to continue as a going concern exists when aggregate conditions and events indicate it is *probable* that the entity will not be able to meet its obligations as they are due during the year following the date the financial statements are available to be issued. The guidance, in defining substantial doubt, uses the term *probable*, which means likely to occur. Therefore, under GAAP, the issue is considered to exist even if the situation will not definitely occur. However, GAAP is not the defining guidance for special purpose frameworks in this area.]
 - c. Consideration of the entity's ability to continue as a going concern must be assessed at least once a year. [This answer is correct. According to AR-C 90.65, when the entity uses a financial reporting framework that does not specify a forward-looking time period for management to consider any going concern issue, then a reasonable time period is one year from the date the financial statements were reviewed. This period also seems appropriate for prepared or compiled financial statements.]**
 - d. Whether or not there is substantial doubt, management must have a mitigating plan available. [This answer is incorrect. If conditions and events that raise doubt about an entity's ability to continue as a going concern exist, management would consider mitigating plans and whether those plans alleviate the substantial doubt. Therefore, under GAAP, management does not need such a plan unless the doubt exists. However, the special purpose framework may not be required to meet all of the GAAP requirements in this area.]

13. Which of the following entities is most likely to have a going concern issue? (Page 146)

- a. EMK Company has positive financial results. [This answer is incorrect. Financial results, including the impact of the basis of accounting on those results, should be considered when determining whether there is substantial doubt about the entity's ability to continue as a going concern. However, because EMK Company had good financial results, this in and of itself would not indicate a going concern issue.]
- b. JEB Company pays off a longstanding loan. [This answer is incorrect. A financial indicator of a going concern issue would be defaulting on a loan agreement. Since JEB Company paid off its loan, it seems to be in a better place financially and the ability to continue as a going concern is not likely to be an issue, at least based solely on this criterion.]
- c. **AGP Company is undergoing legal proceedings. [This answer is correct. External matters that could be indicators of going concern uncertainty include legal proceedings (like those afflicting AGP Company), legislation, or similar matters that might jeopardize the entity's ability to operate. Other external factors that could indicate a problem include losing a principal customer or supplier or an underinsured catastrophe such as a drought, earthquake, or flood.]**
- d. MMZ Company recently signed a new labor contract. [This answer is incorrect. Internal matters that could be indicators of going concern uncertainty include work stoppages or other labor difficulties, substantial dependence on the success of a particular project, and the need to significantly revise operations. Because MMZ Company just signed a new labor contract, it is less likely to be affected by work stoppages or other labor difficulties.]

14. Which of the following statements best describes *nonrecognized subsequent events*? (Page 147)

- a. **They occurred after the end of the reporting period. [This answer is correct. There are two types of subsequent events discussed in FASB ASC 855-10. The second type, referred to as *nonrecognized subsequent events*, provides information that does not indicate that an asset was impaired or a liability was incurred at the end of the reporting period (because the subsequent event occurred after the end of the reporting period) but may require disclosure so the financial statements will not be misleading.]**
- b. They are used when determining the carrying amount at the end of the period. [This answer is incorrect. The first type of subsequent events discussed in FASB ASC 855-10, referred to as *recognized subsequent events*, provide information that should be considered in determining the carrying amount of the asset or liability at the end of the reporting period.]
- c. They are considered pro forma data. [This answer is incorrect. FASB ASC 855-10-50-3 notes that an entity should consider supplementing the historical financial statements with pro forma data or presenting pro forma financial statements if a nonrecognized subsequent event is so significant that disclosure is best made by such pro forma financial data. However, all such events are not considered pro forma data.]
- d. They do not affect financial statements prepared using a special purpose framework. [This answer is incorrect. Q&A 1500.07, *Disclosure Concerning Subsequent Events in Special Purpose Financial Statements*, clarifies that these disclosures should be made in financial statements prepared on the pure cash, modified cash, or income tax basis of accounting. Therefore, use of a special purpose framework does not mean financial statements are immune from the effects of this type of subsequent event.]

CHANGES IN THE FINANCIAL REPORTING FRAMEWORK

FASB ASC 250-10, *Accounting Changes and Error Corrections*, provides guidance on measurement and disclosure of an *accounting change*, which FASB ASC 250-10-20 refers to as 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 income tax basis of accounting to accounting principles generally accepted in the United States of America or vice versa. As a practical matter, the authoritative accounting literature does not address financial reporting frameworks other than accounting principles generally accepted in the United States of America.

It is a best practice to apply a change from one financial reporting framework to another financial reporting framework retrospectively so that the financial statements presented are on the same financial reporting framework. The following are some practical considerations:

- a. If the new financial reporting framework would not have materially changed the results of the prior year, restatement of the prior-year results is unnecessary. Instead—
 - (1) if single-year statements are issued, the ending retained earnings balance shown in the prior year's statements could be shown as the opening balance in the current year's statements.
 - (2) if comparative statements are issued, the prior year's statements could be shown as they were originally issued.
- b. If the use of the current framework would have materially changed the results of the prior year, either—
 - (1) the prior year's statements could be restated using the new financial reporting framework and issued in comparison with the current year's statements, or
 - (2) the current year's statements could be issued alone, with the opening balance of retained earnings restated to the current year's financial reporting framework.

Because the disclosure requirements of FASB ASC 250-10-50 do not apply to a change in the financial reporting framework, they do not have to be considered in special purpose financial statements. Nevertheless, depending on the facts and circumstances, the entity may find disclosure helpful to the users of the financial statements.

To illustrate, assume that in the current year the entity changes from accounting principles generally accepted in the United States of America to the income tax basis of accounting. However, use of the income tax basis in the prior year would not have materially changed the financial statements, and accordingly they are presented in comparison with the current-year financial statements without restatement. To address potential questions as to why financial statements previously portrayed as presenting results in conformity with accounting principles generally accepted in the United States of America are now portrayed as presenting results on the income tax basis of accounting, the entity might find a note such as the following helpful:

NOTE B—CHANGE IN BASIS OF ACCOUNTING

In previous years, the Company prepared its financial statements using accounting principles generally accepted in the United States of America, which did not yield materially different results from those for income tax reporting. This year, however, the separate calculations required by those accounting principles for the new leases described in Note X would yield results

significantly different from those for income tax reporting. Management believes the results for income tax reporting provide the information needed by the primary users of the financial statements, and the separate calculations required by accounting principles generally accepted in the United States of America for the new leases are therefore not cost-effective. Accordingly, the accompanying 20X1 financial statements are prepared on the income tax basis of accounting. The 20X0 statements presented for comparison are the same as originally issued because using the income tax basis would not have changed them materially.

In the situation described in the preceding paragraph, the financial reporting framework described in Note A might be as follows:

The accompanying financial statements have been prepared on the basis of accounting used for income tax reporting. In 20X1, that basis differs from accounting principles generally accepted in the United States of America because the Company charges payments under the new leases described in Note X directly to operations instead of accounting for them as financing the acquisition of an asset. In 20X0, there were no substantive differences between the basis used for income tax reporting and accounting principles generally accepted in the United States of America.

If the prior year in a comparative presentation has been restated to conform with the financial reporting framework used in the current year, the entity may believe the primary users of the financial statements would question why the prior year financial results are different than they were originally reported. If so, the entity may find a note such as the following helpful:

In previous years, Taylor Construction prepared its financial statements using accounting principles generally accepted in the United States of America. Since some of those principles differed from the principles used for income tax reporting, Taylor Construction provided deferred taxes for differences between the bases of assets and liabilities for financial statement and income tax reporting. In 20X1, it adopted the basis of accounting used for income tax reporting as the basis for its financial statements. The accompanying 20X0 financial statements have been restated to conform with the new basis of accounting. Because of the differences from accounting principles generally accepted in the United States of America described in Note A, retained earnings at the beginning of 20X0 are approximately \$50,000 lower, net income for 20X0 is approximately \$10,000 lower, and retained earnings at the end of 20X0 are approximately \$60,000 lower than the amounts previously reported.

This position differs from the position taken in a nonauthoritative Technical Question and Answer at Q&A 9030.10 and the AICPA Practice Aid, which indicate that a change in financial reporting framework from GAAP to a special purpose framework, or from a special purpose framework to GAAP, should be disclosed in the notes to the financial statements. Because FASB ASC 250-10 does not apply to a change in financial reporting framework, which Q&A 9030.10 acknowledges, AU-C 800 does not require its consideration. However, accountants can use their judgment as to whether the disclosures illustrated in this section may be helpful to users of the financial statements.

OMITTING SUBSTANTIALLY ALL DISCLOSURES

Ordinarily the accountant's compilation report should specifically address, as a departure from the requirements of the applicable financial reporting framework, each omitted disclosure of which the accountant is aware. However, the SSARS provide an exception to that requirement when the financial statements omit substantially all of the disclosures that would ordinarily be included in the financial statements. In that situation, the accountant's compilation report need only address the overall omission of substantially all disclosures, without mentioning specific omissions. The AICPA Guide, Paragraph 2.43, notes that financial statement disclosures include those that might appear in the body of the financial statements as well as those that might appear in separate notes to the financial statements.

For example, information about the capital structure may be omitted, regardless of whether that information would otherwise be presented as part of the equity caption in the statement of assets, liabilities, and equity or in a note to

the financial statements. Similarly, the financial statements might be more condensed than they would be for full disclosure presentations. For example, an entity might choose not to show changes in retained earnings or other components of equity and might show major components of expenses, such as selling expenses and administrative expenses, but none of the accounts included in those components.

Nevertheless, management may choose to provide disclosures that might otherwise be omitted. For example, management may decide that, while disclosure of other accounting policies will be omitted, the use of the gross profit method to estimate inventories in the interim financial statements will be a helpful reminder for the primary users of the financial statements. Additionally, if the entity experienced a large loss in the period ending on the date of the statement of assets, liabilities, and equity, it is a best practice to disclose the loss in a note or in the equity section of the statement. If management omits such disclosure, the accountant should carefully consider the guidance in AR-C 80.26, which addresses consideration of whether the omission of substantially all disclosures was undertaken with the intention of misleading users of the financial statements.

Disclosures may be provided through expansion of financial statement captions, such as “inventories, estimated using the gross profit method,” or through the addition of a note following the financial statements. When such notes are added, AR-C 80.A36 indicates that they may be labeled, for example, “Selected Information—Substantially All Disclosures Required by the Income Tax Basis of Accounting Are Not Included.”

THE CONSOLIDATION OF VARIABLE INTEREST ENTITIES

A Look at the Authoritative Literature

All of the authoritative consolidation accounting literature is in FASB ASC 810, which establishes the basic requirement that financial statements should include the consolidated financial results of entities in which the reporting entity has a *controlling financial interest*. While FASB ASC 810 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. The authoritative literature on accounting for a variable interest in a variable interest entity (VIE), which is interspersed throughout FASB ASC 810 in VIE Subsections, provides an instance in which the presumption may be overcome.

The VIE Subsections generally require the reporting entity to consider whether to include in its financial statements the consolidated financial results of another entity even if the reporting entity does not hold a majority voting equity interest in the entity.

FASB ASC 810 generally requires the reporting entity to consider the VIE Subsections if it has one of the following relationships with another entity:

- 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 of asset-backed financings or single-lessee leasing arrangements.

An accounting alternative addressing a defined related party leasing arrangement provides an exception to this requirement. Even if one of the relationships discussed above exists, consideration of the VIE Subsections is not required as long as the relationship has the characteristics that are required for the accounting alternative to be available (FASB ASC 810-10-15-17AA–17AC). If one of the relationships discussed above exists and it does not have the characteristics necessary to apply the accounting alternative, the reporting entity must consider whether it has a variable interest in a VIE because of the relationship.

A relationship that requires the reporting entity to consider whether it has a variable interest in a VIE 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:

- a. the other entity must be a VIE,
- b. the reporting entity must have a variable interest in the entity, *and*
- c. the reporting entity must have a controlling financial interest in the entity.

Generally, an entity is considered to be a VIE if *either* of two 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.

A *variable interest* in a VIE is a contractual, ownership, or other pecuniary interest in the entity that changes with fluctuation in the fair value of the entity's net assets.

The party that has a controlling financial interest in a VIE is considered to be its *primary beneficiary*. In order for the reporting entity to be considered the primary beneficiary, it must have a variable interest in the VIE and have *both* of the following two characteristics:

- a. the power to direct the activities of the VIE that most significantly impact the economic performance of the VIE, *and*
- b. *either* the obligation to absorb losses of the VIE that could potentially be significant *to the VIE* or the right to receive benefits from the VIE that could potentially be significant *to the VIE*.

The determination of whether the reporting entity is the primary beneficiary of the VIE may require the reporting entity to consider the effects of related-party relationships.

This overview is designed to provide general information for determining whether the GAAP measurement and disclosure requirements should be considered in preparing pure cash, modified cash, and income tax basis financial statements. The VIE Subsections are complex and difficult to understand, even for seasoned accountants. Also, there are various current and proposed carve outs and an accounting alternative that may be used. *PPC's Guide to Related Parties (Including Variable Interest Entities)* provides detailed guidance on the GAAP requirements and application of the VIE Subsections.

Considering Whether the Consolidation Requirements of the VIE Subsections Are Relevant to the Pure Cash, Modified Cash, or Income Tax Basis. The requirements of the VIE Subsections for determining whether consolidation is required in financial statements prepared using generally accepted accounting principles are not relevant to determining whether to present consolidated income tax basis financial statements. Consolidated income tax basis financial statements can be presented only if the reporting entity presents consolidated income tax returns. Consolidation of income tax returns is an election that generally is available only in prescribed circumstances.

The consolidation requirements of the VIE Subsections also are not relevant to pure cash basis financial statements, and they are only relevant to modified cash basis financial statements if one of the modifications of the pure

cash basis is consolidation. As a practical matter, however, small and midsize nonpublic entities that present modified cash basis financial statements are not likely to elect consolidation as a modification.

Considering Whether There Is a Measurement Difference from the VIE Subsections. As discussed at the beginning of this lesson, AU-C 800 and the SSARS, respectively, require financial statements prepared on the pure cash, modified cash, or income tax basis of accounting to describe how the basis differs from generally accepted accounting principles. Some small and midsize nonpublic entities that present pure cash, modified cash, or income tax basis financial statements have determined that the VIE Subsections would require consolidation if their financial statements were instead prepared using generally accepted accounting principles.

For example, some entities that had previously prepared their financial statements using generally accepted accounting principles, elected to prepare their financial statements using the income tax basis of accounting when they determined that the VIE Subsections required consolidation. Those entities were concerned that consolidated financial statements would not provide the entity-specific information that lenders needed to evaluate creditor agreements. The entities also noted that lenders were willing to accept income tax returns in lieu of financial statements that included variable interest entities as required by GAAP.

Determining whether the VIE Subsections cause a difference between generally accepted accounting principles and the basis of accounting used to prepare the financial statements requires determining whether that authoritative literature would require consolidation.

If the reporting entity knows that consolidation would be required, the absence of consolidation should be disclosed as a difference between the basis of accounting used and generally accepted accounting principles. The following illustrates appropriate disclosure in the financial statements of ABC Company when the VIE Subsections would require including in its financial statements, the consolidated financial results of DEF Company, and shows an example of a disclosure of the difference between the special purpose framework and GAAP as required by AU-C 800 and the SSARS. The illustrative disclosure is designed to follow the description of other differences in the notes to the financial statements.

In addition, accounting principles generally accepted in the United States of America would require consolidating in the financial statements the financial results of DEF Company.

If the reporting entity has not determined whether consolidation would be required, it is a best practice to consider whether a relatively straightforward determination could be made. For example, the reporting entity may be able to readily determine that a different related party is the primary beneficiary and therefore consolidation would not be required.

The characteristics identifying the holder of a variable interest in a VIE as the primary beneficiary were listed earlier in this discussion. An entity determined to be the primary beneficiary is required to consolidate the financial results of the VIE in its financial statements.

Therefore, if the reporting entity can identify a related party other than the reporting entity that has the characteristics of a primary beneficiary, additional consideration by the reporting entity of whether there is a measurement difference from the VIE Subsections is unnecessary. That is because the reporting entity could not be considered to be the primary beneficiary. Consolidation would therefore not be required.

If a relatively straightforward determination cannot be made, the reporting entity could consider whether there is a reasonable possibility that consolidation would be required.

- a. If there is a reasonable possibility that consolidation would be required, it is a best practice for the reporting entity to disclose that generally accepted accounting principles may require consolidation. The following illustrates appropriate disclosure in the financial statements of ABC Company when there is a reasonable possibility that the VIE Subsections would require including in its consolidated financial statements the financial results of DEF Company. The illustrative disclosure is designed to follow the description of other differences.

In addition, accounting principles generally accepted in the United States of America may require consolidating in the financial statements the financial results of DEF Company.

- b. If there is not a reasonable possibility that consolidation would be required, it is a best practice not to mention the possibility that generally accepted accounting principles would require consolidation.

Considering Disclosure Required by the VIE Subsections. FASB ASC 810-10-50 prescribes disclosures for when the reporting entity is the primary beneficiary of a VIE and when the reporting entity has a variable interest in a VIE but is not its primary beneficiary. FASB ASC 810-10-50-2AA states that the principal objectives of the disclosure requirements are to provide users of the financial statements with an understanding of all of the following:

- a. The significant judgments and assumptions made by the reporting entity in determining whether consolidation or disclosure of a VIE is required.
- b. The nature of restrictions on consolidated assets and liabilities of a VIE and their carrying amounts.
- c. The nature of risks from the reporting entity's involvement with the VIE and changes in those risks.
- d. How involvement with the VIE affects the reporting entity's financial position, financial performance, and cash flows.

As previously discussed, the consolidation requirements of the VIE Subsections are not relevant to financial statements prepared using the income tax or pure cash basis, and they likely would not be relevant to financial statements prepared using the modified cash basis. The objectives in the previous paragraph for disclosure of consolidation of a VIE also are not relevant to financial statements prepared using the income tax or pure cash basis and are not likely to be relevant to financial statements prepared using the modified cash basis.

The objectives that would be relevant for disclosure in pure cash, modified cash, and income tax basis financial statements are those that do not relate to consolidation:

- a. The significant judgments and assumptions made by the reporting entity in determining whether disclosure of a VIE is required.
- b. The nature of risks from the reporting entity's involvement with the VIE and changes in those risks.
- c. How involvement with the VIE affects the reporting entity's financial position, financial performance, and cash flows.

Disclosing information that meets these objectives seems to provide information that communicates the substance of the disclosures that would be required by the VIE Subsections.

If the reporting entity elects the accounting alternative outlined beginning at FASB ASC 810-10-15-17AA, only the following disclosures are required beyond those that may be required by other GAAP:

- a. The key terms and amounts of obligations of the lessor entity that expose the reporting entity to providing financial support to the lessor entity.
- b. A qualitative description of any other circumstances that expose the reporting entity to providing financial support to the lessor entity.

Those disclosures are required only if the relationship with the lessor entity exposes the reporting entity to providing financial support.

Whether or not there is such a possibility, the reporting entity should provide other relevant disclosures, such as those required related to leases, related parties, and guarantees.

Recommendations for the Pure Cash, Modified Cash, and Income Tax Basis

If the reporting entity has a relationship with an entity that has the characteristics allowing it to use the accounting alternative, it is a best practice for pure cash, modified cash, and tax basis financial statements to take the position

that GAAP would not *require* consolidation and therefore there would be no measurement difference. That is because the accounting alternative would be available to the reporting entity. In addition, the financial statements should communicate the substance of the disclosure requirements described above for the accounting alternative if the relationship exposes the reporting entity to providing financial support to the lessor entity.

If the reporting entity has a relationship with another entity that meets the conditions discussed at the beginning of this section but does not have the characteristics required for use of the accounting alternative, the VIE Subsections would need to be considered, including the disclosures discussed in the "Considering Disclosure Required by the VIE Subsections" paragraph.

Illustration of Disclosure When the VIE Subsections Do Not Need to Be Considered. To illustrate disclosure considerations, assume the following:

- a. ABC Company is the reporting entity.
- b. Lane Samuels owns substantially all the equity of ABC Company and owns all the equity of DEF Company.
- c. ABC Company leases its operating facilities from DEF Company under an arrangement that is renewable annually.
- d. Rent expense under the lease is disclosed in the statement of results of operations—income tax basis.
- e. Lane Samuels guarantees the bank debt of DEF Company.
- f. The carrying amount of that debt is \$700,000.

In addition, assume that Lane Samuels controls both ABC Company and DEF Company, the only activity between the two entities is leasing, and ABC Company does not guarantee the debt of DEF Company or provide collateral for it.

First assume that ABC Company concludes that the arrangement with DEF Company does not expose it to the reasonable possibility of providing financial support. Among other things, the lease payments are in line with market conditions and provide DEF Company with sufficient funds to cover debt service, operating expenses, and property improvements.

ABC Company therefore concludes that the disclosure requirements of FASB ASC 810-10-50-2AD do not apply. However, the leasing disclosure requirements of FASB ASC 840-10-50 and 840-20-50 apply (except that since the lease is renewable annually, FASB ASC 840-20-50-2 does not require disclosure of lease commitments). In addition, the related-party disclosure requirements of FASB ASC 850-10-50 apply. An example of appropriate disclosure follows:

Since 20X1, ABC Company has leased its operating facilities from DEF Company under a lease that is renewed annually. Lane Samuels, who owns substantially all the equity of ABC Company, owns all the equity of DEF Company.

Next assume that ABC Company concludes that there is a reasonable possibility it would be required to provide financial support to DEF Company. Among the things ABC Company considered in reaching that conclusion are the following:

- a. The property needs significant improvements to continue to be used as operating facilities for ABC Company.
- b. Because of the depressed real estate market, DEF Company would be unable to obtain financing for the improvements.
- c. Lane Samuels is nearing retirement and has few liquid assets.

ABC Company therefore concludes the disclosure requirements of FASB ASC 810-10-50-2AD apply, as well as the leasing disclosure requirements of FASB ASC 840-10-50 and 840-20-50 and the related-party disclosure requirements of FASB ASC 850-10-50. An example of appropriate disclosure follows:

Since 20X1, ABC Company has leased its operating facilities from DEF Company under a lease that is renewed annually. Lane Samuels, who owns substantially all the equity of ABC Company, owns all the equity of DEF Company and guarantees the debt of DEF Company. The carrying amount of that debt at the end of the year was \$700,000. The debt is secured by the operating facilities and is payable to a bank in monthly installments through April 20X6 when the \$600,000 remaining principal balance is due. The debt bears interest at .5% above the bank's base rate, which resets periodically. However, the interest will not be less than 4%, which was the rate at the end of the year.

Illustration of Disclosure When the VIE Subsections Must Be Considered. The disclosures required when the reporting entity has a variable interest in a VIE but is not its primary beneficiary generally look at the risk a related-party relationship presents for the reporting entity. The authoritative literature on accounting for contingencies that is in FASB ASC 450-20-50-9 notes that disclosure of loss contingencies may be necessary to keep the financial statements from being misleading. It is a best practice to evaluate the disclosure requirements of the VIE Subsections when the reporting entity has a variable interest in a VIE but is not its primary beneficiary in that context, and accordingly pure cash, modified cash, and income tax basis financial statements should disclose information that meets the objectives, which should provide information that communicates the substance of the disclosures that would be required by the VIE Subsections.

To illustrate information that meets those objectives, assume the following—

- a. ABC Company is the reporting entity, operates retail stores, and is a VIE.
- b. Sally Smith owns substantially all the equity of ABC Company.
- c. Sally formed DEF Company to acquire property, lease part of the property to ABC Company, and use the rest of the property to operate a wholesale distribution business. ABC Company will acquire a significant amount of its inventory from DEF Company. The accounting alternative discussed previously is not available because leasing activities do not comprise substantially all activities between the reporting entity and the lessor entity. However, because condition a. listed at the beginning of this section exists, the guidance in the VIE Subsections must be considered.
- d. Rent expense is disclosed in the statement of results of operations—income tax basis.
- e. Sally and ABC Company guarantee the bank debt of DEF Company.
- f. The carrying amount of that debt is \$700,000.

The following illustrates appropriate disclosure by ABC Company—

Since 20X1, ABC Company has leased its operating facilities from DEF Company under a lease that is renewed annually. The real estate and the related bank debt comprise most of the carrying amount of the assets and liabilities of DEF Company. Sally Smith, who owns substantially all of the equity of ABC Company, owns all of the equity of DEF Company and she and ABC Company guarantee the debt of DEF Company. The carrying amount of that debt at the end of the year was \$700,000.

Parent-entity Financial Statements

Some accountants questioned whether a reporting entity could issue financial statements as a parent company, typically referred to as parent-entity financial statements, instead of consolidating under the authoritative literature on accounting for a variable interest in a variable interest entity. However, the authoritative consolidation accounting literature in FASB ASC 810-10-45-11 says that parent-entity financial statements are not a valid substitute for consolidated financial statements.

However, the issue of whether a reporting entity can present parent-entity financial statements in lieu of consolidated financial statements is not relevant to pure cash, modified cash, or income tax basis financial statements.

- a. Since there is no requirement for consolidation to be a modification of the pure cash basis, the issue of whether a reporting entity can present parent-entity pure cash or modified cash basis financial statements to avoid a requirement to consolidate is not relevant.
- b. Since the measurement principles in income tax basis financial statements are the ones used to prepare the reporting entity's income tax returns, an entity that files consolidated tax returns cannot issue parent-entity income tax basis 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.

15. If an entity changes from GAAP to a special purpose framework or back again, when would it be a best practice to restate the prior-year statements, as well?
 - a. When comparative statements are presented.
 - b. When single-year statements are presented.
 - c. When the new framework materially changes the results.
 - d. Prior-year statements are always required to be restated.
16. Which of the following entities has a relationship that triggers consideration as to whether it is a variable interest entity (VIE)?
 - a. Approximately 30% of Entity 1's activities involve or are conducted on behalf of its reporting entity.
 - b. Entity 2's reporting entity provides one third of its subordinated financial support.
 - c. The primary activities Entity 3 engages in are related to selling goods and services.
 - d. Entity 4's reporting entity and its related parties redesigned Entity 4's organization.
17. Assuming all other conditions are met, which of the following would indicate an entity is a VIE?
 - a. The entity has enough equity to fund its own activities.
 - b. Its equity investors have the power to direct the entity's activities.
 - c. Its equity investors are not required to absorb its losses.
 - d. The entity has a relationship with its reporting entity that could require consolidation.
18. Which of the following additional disclosures is needed when the accounting alternative from FASB ASC 810-10-15-17AA is used and the reporting entity is required to provide financial support to the lessor entity?
 - a. Relevant information about any substantive events that affect the reporting entity or the lessor entity.
 - b. The difference between the basis of accounting used and GAAP, if there is an absence of consolidation.
 - c. How involvement with the VIE has affected the reporting entity's financial position, cash flows, and financial performance.
 - d. A qualitative description of circumstances that require the reporting entity to provide financial support.

19. Which of the following statements best describes an issue related to how the VIE Subsections affect special purpose financial statements?
- a. Entities with cash or tax basis financial statements cannot avoid consolidation by presenting parent-entity financial statements.
 - b. If such a reporting entity has a variable interest in a VIE but is not the primary beneficiary, additional disclosures are not needed.
 - c. If such a reporting entity has a relationship with an entity that uses the accounting alternative, consolidation is required.
 - d. The VIE Subsections generally are not relevant to entities that use special purpose 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.)**

15. If an entity changes from GAAP to a special purpose framework or back again, when would it be a best practice to restate the prior-year statements, as well? **(Page 157)**
- a. When comparative statements are presented. [This answer is incorrect. The necessity of restatement is possible when comparative statements are presented; however, there is still another factor that would need to be considered before the final decision is made.]
 - b. When single-year statements are presented. [This answer is incorrect. The entity is unlikely to need to restate the entire prior-year statements when only single-year statements are issued. Restating the opening balance of retained earnings related to the current year's financial reporting framework might be all that is necessary.]
 - c. **When the new framework materially changes the results. [This answer is correct. If use of the new framework would have materially changed the results of the prior year, entities should either (1) restate the prior year's statements using the new financial reporting framework and issue in comparison with the current year's financial statements or (2) issue the current year's statements alone, with the opening balance of retained earnings restated to the current year's financial reporting framework. The option chosen would depend on what type of financial presentation is used; however, the material difference in the amount is a key deciding factor. Without such a material difference, the prior year's statements could be shown in a comparative presentation as they were originally issued.]**
 - d. Prior-year statements are always required to be restated. [This answer is incorrect. There are instances where restatement of the entirety of the prior-year statements would not be necessary.]
16. Which of the following entities has a relationship that triggers consideration as to whether it is a variable interest entity (VIE)? **(Page 159)**
- a. Approximately 30% of Entity 1's activities involve or are conducted on behalf of its reporting entity. [This answer is incorrect. According to FASB ASC 810, the relationship that would trigger VIE consideration is when 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. Entity 1 does not perform enough activities in this manner for consideration to be required.]
 - b. Entity 2's reporting entity provides one third of its subordinated financial support. [This answer is incorrect. As described in FASB ASC 810, consideration of the VIE Subsections is needed when the reporting entity and its related parties provide more than half of the entity's subordinated financial support. Entity 2 is not receiving that much support in this scenario.]
 - c. The primary activities Entity 3 engages in are related to selling goods and services. [This answer is incorrect. For consideration of the VIE Subsections to be triggered, per FASB ASC 810, the activities of the entity must primarily be related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements. This is not the case for Entity 3.]
 - d. **Entity 4's reporting entity and its related parties redesigned Entity 4's organization. [This answer is correct. FASB ASC 810 generally requires the reporting entity to consider the VIE Subsections if it has one of four types of relationships. One of those relationships is that the reporting entity, its related parties, or both participated significantly in the design or redesign of the entity, which is what occurred to Entity 4 in this scenario.]**

17. Assuming all other conditions are met, which of the following would indicate an entity is a VIE? **(Page 160)**
- a. The entity has enough equity to fund its own activities. [This answer is incorrect. One of the conditions that must be met for an entity to be considered a VIE is that its equity is *not* sufficient to finance the entity's activities without additional subordinated financial support.]
 - b. Its equity investors have the power to direct the entity's activities. [This answer is incorrect. To be considered a VIE, the entity's equity investors *cannot* have the power to direct the activities of the entity that most significantly impact its economic performance.]
 - c. **Its equity investors are not required to absorb its losses. [This answer is correct. 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 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, and (3) the right to receive its benefits.]**
 - d. The entity has a relationship with its reporting entity that could require consolidation. [This answer is incorrect. A relationship that requires the reporting entity to consider whether it has a variable interest in a VIE 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.]
18. Which of the following additional disclosures is needed when the accounting alternative from FASB ASC 810-10-15-17AA is used and the reporting entity is required to provide financial support to the lessor entity? **(Page 162)**
- a. Relevant information about any substantive events that affect the reporting entity or the lessor entity. [This answer is incorrect. If there are subsequent events, a subsequent events disclosure may be needed; however, subsequent events disclosures are a different consideration than the one outlined in the question above.]
 - b. The difference between the basis of accounting used and GAAP, if there is an absence of consolidation. [This answer is incorrect. If the reporting entity knows that consolidation would be required, the absence of consolidation should be disclosed as a difference between the basis of accounting used and GAAP. However, the issue of consolidation is a separate consideration than the one discussed in this question. Therefore, there is a better answer choice.]
 - c. How involvement with the VIE has affected the reporting entity's financial position, cash flows, and financial performance. [This answer is incorrect. FASB ASC 810-10-50-2AA states that the principal objectives of the VIE Subsections' disclosure requirements are to provide users of the financial statements with an understanding of specific information, including how involvement with the VIE affects the reporting entity's financial position, financial performance, and cash flows. However, the disclosures required in this guidance are not depending on the accounting alternative mentioned above. Therefore, a different answer choice is needed.]
 - d. **A qualitative description of circumstances that require the reporting entity to provide financial support. [This answer is correct. If the reporting entity elects the accounting alternative outlined beginning in FASB ASC 810-10-15-17AA, only two disclosures are required beyond those that may be required by other GAAP: (1) the key terms and amounts of obligations of the lessor entity that expose the reporting entity to providing financial support to the lessor entity and (2) a qualitative description of any other circumstances that expose the reporting entity to providing financial support to the lessor entity. Those disclosures are required only if the relationship with the lessor entity exposes the reporting entity to providing financial support.]**

19. Which of the following statements best describes an issue related to how the VIE Subsections affect special purpose financial statements? **(Page 165)**
- a. **Entities with cash or tax basis financial statements cannot avoid consolidation by presenting parent-entity financial statements. [This answer is correct. The issue of whether a reporting entity can present parent-entity financial statements in lieu of consolidated financial statements is not relevant to pure cash, modified cash, or income tax basis statements. Therefore, using parent-entity statements would not be appropriate.]**
 - b. If such a reporting entity has a variable interest in a VIE but is not the primary beneficiary, additional disclosures are not needed. [This answer is incorrect. It is a best practice to evaluate the disclosure requirements of the VIE Subsections when the reporting entity has a variable interest in the VIE but is not its primary beneficiary in that context, and accordingly pure cash, modified cash, and income tax basis financial statements should disclose information that meets the objectives, which should provide information that communicates the substance of the disclosures that would be required by the VIE Subsections.]
 - c. If such a reporting entity has a relationship with an entity that uses the accounting alternative, consolidation is required. [This answer is incorrect. If the reporting entity has a relationship with an entity that has the characteristics allowing it to use the accounting alternative, it is a best practice for pure cash, modified cash, and tax basis financial statements to take the position that GAAP would *not require* consolidation and, therefore, there would be no measurement difference.]
 - d. The VIE Subsections generally are not relevant to entities that use special purpose financial statements. [This answer is incorrect. AU-C 800 and the SSARS, respectively, require financial statements prepared on the pure cash, modified cash, or income tax basis of accounting to describe how the basis differs from GAAP. Some small and midsize nonpublic entities that present pure cash, modified cash, or income tax basis financial statements have determined that the VIE Subsections would require consolidation if their financial statements were instead prepared using GAAP. Therefore, the VIE Subsections would have to be at least consulted to determine whether or not they apply; they should not be completely dismissed.]

APPROPRIATE ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES

A Look at GAAP Measurement Principles

Depending on the facts and circumstances, there may be varying views on the appropriate income tax treatment of a transaction. Therefore, there may be uncertainty about whether a tax position would be sustained by the taxing authority if it examined the position. Under FASB ASC 740-10, *Income Taxes*, computations of current and deferred income tax assets and liabilities should only consider tax positions that, more-likely-than-not, would be sustained if the taxing authority examined the positions. For this purpose, the phrase “more-likely-than-not” means that there is greater than a 50% chance.

FASB ASC 740-10 requires a two-step approach to recognizing tax benefits: determining whether a tax benefit should be recognized and looking at how to measure a tax benefit that is recognized. Whether a tax benefit should be recognized depends on whether the benefit is, or will be, derived from a tax position that meets the “more-likely-than-not” criterion. A tax benefit should only be recognized if the tax position meets the criterion. The entity must assess the likelihood that a tax position would be sustained by assuming that the taxing authority will examine the return in which the position is, or will be, taken, and that the taxing authority will examine the position. The guidance prohibits considering the possibility that a return may not be examined and that, even if a return is examined, the position may not be examined.

The recognized tax benefit should be measured as the largest amount of tax benefit for which there is greater than a 50% chance of realization after an assumed examination by a taxing authority with complete knowledge of all relevant information related to the tax position. The largest amount of tax benefit should be determined using facts and circumstances available and should consider likely outcomes.

To illustrate, assume that an entity develops a tax position under which it will claim a deduction for an expense. If the entity believes there is *no more than a 50% chance* the taxing authority would accept the position, the entity should recognize no tax benefit from the deduction in its financial statements. However, if the entity believes there is *greater than a 50% chance* the taxing authority would accept the position, the entity should recognize the tax benefit for which there is greater than a 50% chance of realization upon settlement with the taxing authority.

If the entity believes there is greater than a 50% chance the full deduction would be allowed, the tax benefit of the full deduction should be recognized. However, if the entity believes it would likely settle with the taxing authority by agreeing to a deduction for less than the full amount originally deducted, or that the taxing authority would disallow part of the deduction, the entity should recognize a tax benefit for only the portion of the deduction expected to be ultimately accepted. That amount can be determined qualitatively or quantitatively:

- a. A *qualitative* assessment could be made a variety of ways. For example, it could be made based on the accountant's experience with comparable situations, or based on the accountant's understanding of the direction rulings by the taxing authority tend to take.
- b. A *quantitative* assessment could be made based on different probability scenarios under which the amount recognized is the largest amount above a cumulative probability greater than 50%.

FASB ASC 740-10-50 requires providing for the effect of interest and penalties on the liability for tax benefits that have been realized but have not been recognized.

Consideration of Uncertainty in Income Taxes in Income Tax Basis Financial Statements

Measurement Principles. The measurement principles used to prepare income tax basis financial statements are determined solely by the measurement principles used to prepare the income tax return. Therefore, the tax provision reported in income tax basis financial statements is the amount of income taxes reported in the income tax returns.

Disclosure of the Primary Differences from Generally Accepted Accounting Principles. As discussed earlier in this lesson, financial statements prepared on the income tax basis of accounting should describe how the basis of accounting used differs from generally accepted accounting principles. Depending on the facts and circumstances, the reporting entity may be able to readily determine whether the measurement of income taxes in income tax basis financial statements would differ materially from the GAAP requirements. Many small and midsize nonpublic entities incur taxable income primarily through routine business transactions, and their deductions are based on clear and unambiguous tax law.

In those situations, the entity is highly confident that there is far better than a 50% chance that the deductions would be sustained under examination. FASB ASC 740-10-25-6 only requires that the probability be greater than 50%. Therefore, under generally accepted accounting principles, the amount of income taxes reported in the tax return would be reported as the current tax provision in the financial statements, and generally there would be no difference from the amount reported in the income tax basis statements.

Small and midsize nonpublic entities that know there is risk in their position on the deductibility of certain expenses typically have estimated the probability of an unfavorable outcome as part of their analysis of which tax position to take. However, all that is needed to determine whether there is a difference between the amount of income taxes reported in income tax basis financial statements and the amount that GAAP would require reporting is a determination of whether the chance that the position would be sustained upon examination is greater than 50%.

- a. If the chance is greater than 50%, there is no difference between the tax provision reported in income tax basis financial statements and the amount FASB ASC 740-10 would require reporting.
- b. Otherwise, there is a difference between the tax provision reported in income tax basis financial statements and the amount FASB ASC 740-10 would require reporting, and, if the difference would likely be material, disclosure of the difference is required.

The following provides an example of appropriate disclosure added after the description of other significant differences.

In addition, income taxes are reported at the amount reported in the income tax returns. Under accounting principles generally accepted in the United States of America, the amount reported would be based on probability assessments of the likelihood that certain deductions would be disallowed upon examination because the taxing authorities interpreted existing guidance differently.

Consideration of Uncertainty in Income Taxes in Cash and Modified Cash Basis Financial Statements

Applying the Step Approach in Modifying the Pure Cash Basis to Recognize Income Tax Assets and Liabilities. Modifications of the pure cash basis of accounting should (a) conform with generally accepted accounting principles, (b) make sense, and (c) not be so extensive that the presentation becomes in substance a presentation prepared using generally accepted accounting principles. It is a best practice to limit use of the modified cash basis to entities whose operations are—

- oriented toward cash receipts and disbursements,
- not significantly influenced by financing of sales or purchases, and
- 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.

A modification of the pure cash basis can be viewed in steps. For example, depending on the facts and circumstances, a modification to recognize an asset for operating real estate purchased during the year may not require also depreciating the amount recognized. Similarly, a modification to recognize an asset for debt and equity securities purchased during the year may not require also recognizing subsequent unrealized appreciation and depreciation in the fair value of the securities.

However, it is a best practice for any step modification to conform with generally accepted accounting principles. For example, a modification to depreciate assets recognized for property and equipment should use depreciation methods that would be acceptable under generally accepted accounting principles. Similarly, a modification to capitalize the purchase price of operating real estate or debt and equity securities needs to measure the assets at the total purchase price, not just the down payment.

Under the pure cash basis, income taxes are reported as the amount paid or received during the period, with payments of income taxes reported as cash disbursements and receipts of income tax refunds reported as cash receipts. Assets are not recognized for overpayments of income taxes, and liabilities are not recognized for income taxes due. Depending on the facts and circumstances, an entity may therefore elect to modify the pure cash basis to recognize income tax assets and liabilities. Applying the step approach to recognizing income tax assets and liabilities in modified cash basis financial statements raises two questions:

- a. Does the modification require recognizing both current and deferred income tax assets and liabilities?
- b. Should FASB ASC 740-10 be considered in measuring the income tax assets and liabilities recognized?

Does a Modification to Recognize Income Tax Assets and Liabilities Require Recognizing Both Current and Deferred Income Tax Assets and Liabilities? The carrying amounts of assets and liabilities recognized in modified cash basis financial statements may differ from their basis for income tax reporting. For example, a decision to modify the pure cash basis to capitalize and depreciate the cost of equipment may result in depreciating the cost slower in the financial statements than in the income tax returns. If an entity elects to modify the pure cash basis to recognize income tax assets and liabilities, whether the entity recognizes only current income tax assets and liabilities or both current and deferred income tax assets and liabilities will depend on the facts and circumstances.

Current, but Not Deferred, Income Tax Assets and Liabilities Are Recognized. To illustrate facts and circumstances that may lead the entity to conclude that it will modify the pure cash basis to recognize current, but not deferred, income tax assets and liabilities, assume that the entity prepares its financial statements using the pure cash basis modified to recognize, but not depreciate, an asset for its operating real estate, to recognize a liability for the related debt, and to recognize income tax assets and liabilities. The entity plans to hold the real estate for the foreseeable future and believes the primary users of the financial statements are not concerned about the difference between the gain that would be recognized for financial statement and income tax reporting of the ultimate disposition of the property. In this set of facts and circumstances, the entity would likely conclude that only recognizing current income tax assets and liabilities is sufficient for its reporting purposes and that recognizing the deferred income tax liability for the taxable difference in accounting for the real estate is unnecessary.

Both Current and Deferred Income Tax Assets and Liabilities Are Recognized. To illustrate facts and circumstances that may lead the entity to conclude that it will modify the pure cash basis to recognize both current and deferred income tax assets and liabilities, assume that the entity prepares its financial statements using the pure cash basis modified to recognize investments in debt and equity securities and the unrealized appreciation and depreciation in their fair value and to recognize income tax assets and liabilities. The entity believes the primary users of the financial statements are mainly interested in cash flow consequences and that the financial statements should clearly communicate that realizing changes in the fair value of the securities would have tax implications that would alter cash flows. In this set of facts and circumstances, the entity would likely conclude that recognizing both current and deferred income tax assets and liabilities is relevant to the primary users of the financial statements.

Should FASB ASC 740-10 Be Considered in Measuring the Income Tax Assets and Liabilities Recognized?

This course recommends that each modification under the step approach be in conformity with generally accepted accounting principles; therefore, it would not be appropriate to modify the pure cash basis to recognize an asset or liability at its income tax basis when that would cause a material difference from the carrying amount that would be determined using generally accepted accounting principles. For example, it would not be appropriate to modify the pure cash basis to recognize an asset for equipment and to depreciate the asset using the method used for income tax reporting if that method would yield results that are materially different from those using methods acceptable under generally accepted accounting principles.

Similarly, it is a best practice for a modification to recognize only current income tax assets and liabilities or both current and deferred income tax assets and liabilities to consider FASB ASC 740-10 in measuring the income tax assets and liabilities recognized. Therefore, earnings reported in the modified cash basis financial statements would only recognize the tax benefit of tax positions that meet the “more-likely-than-not” criterion for recognizing tax benefits.

As a practical matter, however, entities to which this course recommends limiting use of the modified cash (described previously) are not likely to have tax positions that do not meet the “more-likely-than-not” criterion.

Disclosure of the Primary Differences from Generally Accepted Accounting Principles. As discussed earlier in this lesson, financial statements prepared on the pure cash or modified cash basis of accounting should describe how the basis of accounting used differs from generally accepted accounting principles. In pure cash basis financial statements, a generic description such as the illustrative disclosure provided earlier in this lesson ordinarily is sufficient to describe the primary differences from generally accepted accounting principles. If modifications to the pure cash basis do not include recognizing accrued income taxes, there may be a difference between the income taxes reported in the financial statements and the amounts that FASB ASC 740-10 would require reporting. Analogous guidance on determining whether there is a difference and an illustrative disclosure was provided at the beginning of this section.

Consideration of GAAP Disclosure Requirements for Uncertainty in Income Taxes in Special Purpose Financial Statements

A Look at GAAP Disclosure Requirements. The income tax disclosure requirements for nonpublic entities are located in seven sections of FASB ASC 740-10-50:

- a. FASB ASC 740-10-50-2 through 50-5 and FASB ASC 740-10-50-8, referred to as *statement of financial position related disclosures*.
- b. FASB ASC 740-10-50-9 and 50-10, referred to as *income statement related disclosures*.
- c. FASB ASC 740-10-50-11, 50-13, and 50-14, referred to as *income tax expense compared to statutory expectations*.
- d. FASB ASC 740-10-50-15, referred to as *unrecognized tax benefit related disclosures*.
- e. FASB ASC 740-10-50-17, referred to as *entities with separately issued financial statements that are members of a consolidated tax return*.
- f. FASB ASC 740-10-50-18 through 50-20, referred to as *policy related disclosures*.
- g. FASB ASC 740-10-50-21, referred to as *other disclosures*.

FASB ASC 740-10-50-19 requires disclosure of the entity's policy on classification of interest and penalties. All of the other disclosures about uncertain tax positions are included in FASB ASC 740-10-50-15. Characterizing those disclosures as *unrecognized tax benefit related disclosures* suggests that they only need to be considered if there are unrecognized tax benefits because the more-likely-than-not criterion has not been met for one or more tax positions. (FASB ASC 740-10-20 defines *tax position* as, “A position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods.”)

The requirements in FASB ASC 740-10-50-15 are to disclose:

- a. The total amounts of interest and penalties recognized in the statements of financial position and results of operations.
- b. For tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date:
 - (1) the nature of the uncertainty,

- (2) the nature of the event that could occur in the next 12 months that would cause the change, and
 - (3) an estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.
- c. A description of tax years that are subject to examination by major tax jurisdictions (often referred to as *open tax years*).

Applicability to Small and Midsize Nonpublic Entities. The disclosure requirements of FASB ASC 740-10-50-15 and 50-19 *only* need to be considered by small and midsize nonpublic entities if the entity has material amounts of unrecognized tax benefits because one or more significant tax positions do not meet the more-likely-than-not criterion.

- a. The required disclosures of tax positions for which it is reasonably possible unrecognized tax benefits will change significantly within the next 12 months clearly can apply only when an entity has tax positions that do not meet the more-likely-than-not criterion.
- b. The requirement to disclose the entity's policy for classifying interest and penalties was clearly established in the context of accounting for the tax effects of tax positions that do not meet the more-likely-than-not criterion.
- c. The disclosure of interest and penalties recognized in the statements of financial position and results of operations would not be necessary if no material amounts of unrecognized tax benefits were included in either statement.
- d. Small and midsize nonpublic entities may not have significant tax positions that do not meet the more-likely-than-not criterion. An AICPA Technical Question and Answer at Q&A 5250.15 had noted that a description of tax years that remain subject to examination should be provided regardless of whether the entity has uncertain tax positions. However, that Q&A was withdrawn in March 2015. Thus, if an entity has no uncertain tax positions, disclosure of open tax years is not required.

Disclosure Considerations in Special Purpose Financial Statements. The GAAP measurement requirements for uncertainty in income taxes would not be relevant in pure cash and income tax basis financial statements, and they would only be relevant in modified cash basis financial statements if one of the modifications was to recognize current or deferred income tax assets and liabilities. However, entities for which this course recommends limiting use of the modified cash basis are not likely to have significant tax positions that do not meet the more-likely-than-not criterion. If the GAAP measurement requirements do not apply, the GAAP disclosure requirements discussed in the previous paragraph do not need to be considered.

Is Some Disclosure of Significant Uncertainty Needed to Keep the Financial Statements from Being Misleading?

For the same reason GAAP disclosure requirements for uncertain tax positions do not need to be considered in financial statements prepared using the pure cash basis, the income tax basis, and ordinarily the modified cash basis—because the GAAP measurement requirements do not need to be considered—the GAAP disclosure requirements for uncertain tax positions also do not need to be considered in personal financial statements prepared using GAAP. The measurement of income taxes in personal financial statements is prescribed by FASB ASC 274-10-35-14 and 35-15, rather than FASB ASC 740-10.

Even if the GAAP disclosure requirements for uncertain tax positions do not need to be considered, it may be necessary to disclose the loss contingency for significant uncertainty in returns for open years to keep the financial statements from being misleading. That requires the exercise of judgment based on the facts and circumstances. Even though the GAAP measurement principles do not apply, the same criterion can be used to determine whether information about a significant uncertain tax position should be disclosed. Therefore, a significant tax position would not be considered for disclosure unless it is not more likely than not that the position would be sustained upon examination by the taxing authority. However, that does not mean that some or all of the disclosure that would be required by GAAP needs to be included in the financial statements.

The following is an illustration of disclosure that might be made in the income tax basis financial statements of a corporation. The disclosure is designed only to put the reader of the financial statements on notice that no provision has been made for the loss contingency arising from the risky tax position. It is patterned after the GAAP disclosure requirements of FASB ASC 450-20-50-3 through 50-5 for unrecognized loss contingencies and therefore includes none of the GAAP disclosure requirements of FASB ASC 740-10-50-15 and 50-19 for income taxes, which assume that a liability has been recognized to defer the benefit of uncertain tax provisions. For example, the only disclosure of open tax years is how long the *tax return with the risky position* is subject to examination.

The provision for federal income taxes is the amount of income taxes reported in the income tax return for the year. The return includes a significant nonrecurring deduction that is based on a tax position for which the Company believes there is substantial authority. Nevertheless, because of the unusual nature of the deduction, there is a reasonable possibility the deduction would be disallowed or reduced if the IRS examines the return and interprets existing guidance differently than the Company interprets it. The amount of any settlement with the IRS in that event cannot be reasonably estimated. The tax return is subject to examination by the IRS through 20X5.

OTHER ITEMS TO CONSIDER

Presentation of Sales and Similar Taxes in the Statement of Results of Operations

Entities often collect taxes (such as sales, use, value added, and certain excise taxes) from customers and send the amounts collected to the appropriate taxing authority. FASB ASC 605-45-50-3 and 50-4 address the presentation of such taxes in the statement of results of operations. FASB ASC 605-45-15-2 applies to any tax a governmental authority assesses that is imposed on and occurs simultaneously with a specific transaction between a seller and a customer that produces revenue. It does not apply to certain tax schemes imposed during the inventory procurement process.

Some entities present sales and similar taxes on a gross basis. That is, they record the amount of taxes collected as revenues and the amount remitted to taxing authorities as costs. Other entities use a net presentation offsetting the taxes against the related revenues. FASB ASC 605-45-45 allows either presentation method and gives factors to consider when selecting a presentation method. The presentation chosen is an accounting policy decision to be disclosed in accordance with FASB ASC 235-10-50-1. However, entities that report sales and similar taxes on a gross basis must disclose the amount of those taxes if they are significant. Such disclosure may be done on an aggregate basis.

It is a best practice to consider the disclosure requirements in cash, modified cash, and income tax basis financial statements. The disclosure should generally be worded the same as it would in financial statements prepared using generally accepted accounting principles. The following illustrates appropriate disclosure.

The state Alcoholic Beverage Control Board imposes a wholesaler's tax on all sales. Taxes imposed on sales during the year are offset against sales, and the net amount is reported as revenue.

Fair Value Considerations

A Look at GAAP Fair Value Measurement Principles. FASB ASC 820, *Fair Value Measurement*, defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and requires disclosures about fair value measurements.

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 guidance applies to recurring and nonrecurring measurements at fair value but does not address when those measurements are

required, either to determine amounts to report in the face of the financial statements or to determine amounts to disclose. For example—

- a. Prior to the effective date of ASU 2016-01, FASB ASC 825-10-50, *Financial Instruments*, requires recurring disclosure of the fair value of financial instruments unless the entity is a nonpublic entity, its assets are less than \$100 million, and it has no derivatives.
- b. FASB ASC 320-10, *Investments—Debt and Equity Securities*, requires investments in equity securities that are available for sale and for which fair value is readily determinable to be measured at their fair value on a recurring basis.
- c. FASB ASC 350, *Intangibles—Goodwill and Others*, requires a nonrecurring adjustment of the carrying amount of intangible assets to their fair value to recognize an impairment loss.

Instead of prescribing when fair value measurements are required, the measurement guidance in FASB ASC 820-10 looks at how fair value should be determined when generally accepted accounting principles require fair value measurement. The guidance accomplishes that by providing a fair value hierarchy consisting of three levels—levels 1, 2, and 3—generally ranging from the most objective determination of fair value to the most subjective.

- a. Level 1 measurements use quoted prices in active markets for *identical* assets or liabilities that the reporting entity has the ability to access at the measurement date.
- b. Level 2 measurements generally use available indirect information, such as quoted prices for *similar* assets or liabilities in active markets, or quoted prices for identical or similar assets or liabilities in markets that are not active.
- c. Level 3 measurements are the most subjective, generally based on the entity's own assumptions developed using the best information available in the circumstances.

Fair value measurements generally should be based on the most objective information available. For example, level 1 measurements should be used whenever possible, and level 3 measurements should only be used when level 1 or level 2 measurements cannot be made. This three-level hierarchy should accommodate most fair value measurements of small and midsize nonpublic entities. However, the authoritative literature acknowledges the possibility that, depending on the facts and circumstances, it may not be practicable to determine the fair value of certain financial instruments.

The Effect of the GAAP Fair Value Measurement Principles on Special Purpose Financial Statements. The measurement guidance will have no effect on financial statements prepared on the pure cash basis because the only asset recognized under that basis is cash and no liabilities are recognized. In addition, as previously discussed, readers of financial statements prepared with a cash orientation likely do not expect to see supplemental fair value information about unrecorded financial instruments that FASB ASC 825-10-50 would require disclosing. (Additionally, those disclosure requirements may no longer be relevant in certain circumstances.)

The measurement guidance in FASB ASC 820 will have no effect on amounts reported in the face of financial statements prepared using the income tax basis of accounting because any fair value measurements should be determined following the requirements for income tax reporting. However, the measurement guidance may affect—

- a. supplemental disclosure of the fair value of financial instruments, as discussed earlier in this lesson.
- b. the description of differences between the income tax basis and generally accepted accounting principles in the highly unlikely event that an asset or liability is required to be reported at fair value under both generally accepted accounting principles and the income tax basis, but as a result of FASB ASC 820, the way fair value is determined is different for income tax reporting.

If an entity modifies the pure cash basis of accounting to recognize an asset or a liability that generally accepted accounting principles require to be measured at fair value, the modification should be in conformity with the

measurement guidance of FASB ASC 825-10. As a practical matter, however, modifications of the cash basis to conform with generally accepted accounting principles that require fair value measurements are likely to only be for debt and equity securities within the scope of FASB ASC 320-10 or FASB ASC 958, *Not-for-Profit Entities*, which generally prescribe level 1 measurements. As discussed earlier in this lesson, the supplemental disclosure requirements of FASB ASC 825-10-50 are not likely to be relevant to financial statements prepared on the modified cash basis of accounting.

The Effect of the GAAP Fair Value Disclosure Requirements on Special Purpose Financial Statements.

Disclosures about fair value measurements are required in GAAP financial statements. Following the guidance in AU-C 800 and the SSARS, special purpose financial statements that have fair value measurements should either provide those same disclosures or provide information that communicates the substance of those requirements. (A Technical Question and Answer at Q&A 1800.06 reaches the same conclusion.)

The disclosure requirements for fair value measurements in a GAAP presentation are prescribed by FASB ASC 820-10-50. FASB ASC 820-10-50-1 sets the overriding objective of the disclosures about fair value measurements, generally requiring disclosure of information that enables users of the financial statements to assess the valuation techniques and inputs used to develop fair value measurements and the effect of fair value measurements based on significant unobservable inputs. To meet that objective, FASB ASC 820-10-50-2 generally requires GAAP financial statements to disclose the following information for assets and liabilities measured at fair value:

- a. The fair value measurements.
- b. The level within the fair value hierarchy in which the fair value measurements in their entirety fall.
- c. Certain information about fair value measurements using significant unobservable inputs.
- d. Certain information about valuation techniques and inputs for fair value measurements.

FASB ASC 820-10-50-2 does not prescribe how that information should be disclosed. For example, while FASB ASC 820 refers to the three categories of inputs as levels 1, 2, and 3, FASB ASC 820-10-50 does not require using those terms to describe the fair value measurements. In addition, it does not preclude combining disclosures. For example, the disclosure of the level within the fair value hierarchy could describe the input and valuation technique.

FASB ASC 820-10-50-8 prescribes presenting the required quantitative disclosures using a “tabular format” in GAAP financial statements. However, in a special purpose framework presentation, the entity would have the option of presenting the required quantitative disclosures using a tabular format or another format that communicates the substance of a tabular format.

To illustrate considering the GAAP fair value disclosure requirements on special purpose financial statements, assume that the financial statements of a 401(k) plan (the Plan) were prepared using the modified cash basis of accounting the Plan uses to file its Form 5500:

- a. The sole modification of the cash basis in the Plan’s Form 5500 has substantial support because it measures securities held by the Plan at their fair value following the requirements of GAAP.
- b. There are two categories of securities—mutual funds and a collective trust fund.
 - (1) Each category is presented as a line item in the statement of net assets available for benefits—modified cash basis.
 - (2) The fair value of the mutual funds is based on quoted prices in active markets.
 - (3) The fair value of the collective trust fund is based on the fair value of the fund’s net assets as determined by the trustee of the fund. The financial statements of the collective trust fund disclose that the fair value measurements of substantially all of the fund’s assets were based on level 2 inputs. Accordingly, substantially all of the fair value of the Plan’s investment in the fund is based on level 2 inputs.

Note B to the financial statements addresses the fair value measurement as part of the summary of significant accounting policies:

Note B—Summary of Significant Accounting Policies

The financial statements have been prepared using the modified cash basis of accounting the Plan uses to file its Form 5500. This basis of accounting differs from accounting principles generally accepted in the United States of America because Employer and participant contributions are recognized in the year they are received instead of the year to which they relate.

The Plan reports financial results on a calendar-year basis. Preparation of financial statements in conformity with the modified cash basis of accounting requires evaluating subsequent events to determine whether they should be considered in determining information reported in the financial statements. The Plan's evaluation of subsequent events was through September 30, 20X1, which is the date the financial statements were available to be issued.

However, under the modified cash basis of accounting, subsequent changes in fair value generally are not considered in the measurement and disclosure of investments. Instead, the Plan's investments are reported at their fair value at the measurement date. The fair value of the investment in mutual funds is based on quoted prices in active markets. The fair value of the investment in the collective trust fund is based on the fair value of the fund's net assets as determined by the trustee of the fund, primarily using quoted prices for similar assets in active markets. The fair value of the investment does not differ materially from its contract value.

Note B to the financial statements conforms with the requirement of AU-C 800.17, AR-C 80.18, and AR-C 90.40 to provide the relevant disclosure that would be required for fair value measurements in a GAAP presentation or provide information that communicates the substance of that disclosure.

- a. *The Fair Value Measurements.* Note B provides this information, stating, "the Plan's investments are reported at their fair value at the measurement date." The statement of net assets available for benefits—modified cash basis shows the two categories of securities: mutual funds and collective trust fund.
- b. *The Level Within the Fair Value Hierarchy in Which the Fair Value Measurements in Their Entirety Fall.*
 - (1) The fair value of the investment in mutual funds was determined based on level 1 inputs, which Note B discloses: quoted prices in active markets.
 - (2) The fair value of the investment in the collective trust fund was determined primarily based on level 2 inputs, which Note B discloses: the fair value of the fund's net assets as determined by the trustee of the fund, primarily using quoted prices for similar assets in active markets.
- c. *Certain Information about Fair Value Measurements Using Significant Unobservable Inputs.* Since there are no material fair value measurements based on level 3 inputs, the GAAP disclosure requirements for measurements based on level 3 inputs are not relevant.
- d. *Certain Information about Valuation Techniques and Inputs Used for Fair Value Measurements.* The valuation techniques and inputs used to measure fair value are disclosed along with the level within the fair value hierarchy in which the fair value measurements in their entirety fall.
- e. *Presenting Required Quantitative Information in a Tabular Format or Another Format That Communicates the Substance of a Tabular Format.* There are only two categories of assets measured at fair value. The fair value of each category is disclosed in the statement of net assets available for benefits—modified cash basis, and Note B provides information about the fair value of each category. The overriding objective of disclosing information that enables users of the financial statements to assess the valuation techniques and inputs used to develop fair value measurements has been met without using the tabular format.

The Fair Value Option. FASB ASC 825-10 permits entities to choose to measure prescribed financial instruments at fair value. Generally, the fair value option is permitted for all financial assets and financial liabilities other than financial assets and financial liabilities that are specifically excluded.

Generally, a *financial asset* is defined as a financial instrument that conveys a right to the entity, and a *financial liability* is defined as a contract that imposes an obligation on the entity. For example, an entity could elect the fair value option for an investment that would otherwise be accounted for using the cost or equity method. Similarly, an entity could elect the fair value option for a fixed-rate long-term note.

The disclosure requirements of FASB ASC 825-10 only apply if an entity has elected the fair value option. Those requirements generally look at how the election affects the measurement of those assets and liabilities. For example, disclosure is required of the reason for electing the fair value option and information about differences between the fair values and contractual cash flows. In addition, the measurement and disclosure requirements of FASB ASC 820 apply to those assets and liabilities.

The Effect of the GAAP Fair Value Option on Special Purpose Financial Statements. In pure cash basis financial statements, cash is the only asset recorded, and no liabilities are recorded. Although cash is a financial asset, its face amount and fair value are the same. Therefore, FASB ASC 825-10 cannot affect financial statements prepared on the pure cash basis of accounting.

The guidance also cannot affect financial statements prepared on the income tax basis. Whether assets and liabilities are measured at fair value in those financial statements depends on the requirements for income tax reporting.

The fair value option guidance is provided with the perspective that the financial statements are prepared using generally accepted accounting principles. It is a best practice for modifications of the pure cash basis to be in conformity with generally accepted accounting principles and that the option of using fair value as an alternative to the measurement required by generally accepted accounting principles should not be considered. As a practical matter, readers of financial statements prepared with a cash orientation do not expect to see assets and liabilities measured at fair value.

Presenting Consolidated or Combined Financial Statements

FASB ASC 810-10-15-10 generally requires the reporting entity to include in its financial statements the consolidated financial results of any entity in which it has a controlling financial interest. While ownership of a majority voting equity interest is the most common way for the reporting entity to have a controlling financial interest in another entity, FASB ASC 810-10-15-8 acknowledges that there are other ways. The reporting entity also has the option of including in its financial statements the combined financial results of a commonly controlled entity. Consolidation and combination generally produce the same results except that the components of equity differ.

In consolidated financial statements, net assets are effectively allocated between two groups of equity investors—the controlling financial interest and the noncontrolling financial interest.

- a. The amount allocated to the controlling financial interest generally is the amount of net assets the reporting entity would recognize in financial statements presented using the equity method. That amount represents the net assets of the reporting entity, including its share of the net assets of the other entities whose financial results are included in the financial statements.
- b. The amount allocated to the noncontrolling financial interest is the share of the other equity investors in the net assets of the other entities whose financial results are included in the financial statements.

To illustrate, assume that the reporting entity has a 70% equity interest in another entity. The equity investors of the reporting entity effectively hold all of its net assets, including its share of the net assets of the other entity. This is considered to be the controlling financial interest in consolidated net assets. The only portion of consolidated net assets that the equity investors of the reporting entity do not hold is the 30% equity interest in the other entity that is held by other investors. This is considered to be the noncontrolling financial interest in consolidated net assets.

In combined financial statements, the equity of each of the combined entities remains intact. The distinction between controlling and noncontrolling financial interests is not relevant. Instead of the reporting entity having a controlling financial interest in other entities whose consolidated financial results are included in the financial statements, another investor has a controlling financial interest in each of the entities whose financial results are included in the financial statements.

Considering Consolidation and Combination in Preparing Pure Cash and Modified Cash Basis Financial Statements. A controlling financial interest in another entity would be recognized in pure cash basis financial statements only if the reporting entity had paid for the interest. The payment would be recognized as a disbursement. The notion of treating the acquisition of a controlling financial interest as a disbursement is inconsistent with the consolidation requirements of FASB ASC 810-10, and, therefore, the consolidation requirements do not seem to apply to pure cash basis financial statements.

The reporting entity could elect to modify the pure cash basis to recognize as an investment payments to acquire a controlling financial interest. It could further elect to modify the pure cash basis to recognize as an investment an obligation to acquire a controlling financial interest. Would those elections require the reporting entity to consolidate the financial results of the entity in which it has a controlling financial interest?

The answer depends on whether consolidation is viewed as a measurement principle or a presentation issue, and accountants differ as to which view is preferable.

- a. *Measurement.* If consolidation is viewed as a measurement principle, the reporting entity should include the consolidated financial results of the controlling financial interests recognized in its modified cash basis financial statements.
- b. *Presentation.* If consolidation is viewed as a presentation issue, the reporting entity should either follow those same consolidation requirements or communicate their substance in some other manner. For example, information about the assets, liabilities, equity, and net income of the entity in which the reporting entity has a controlling financial interest could be communicated through a note to the financial statements.

If consolidated financial statements are prepared for entities using the modified cash basis, this course makes the following suggestions:

- a. The financial results of all entities in which the reporting entity has a controlling financial interest should be consolidated.
- b. The financial results of all consolidated entities should be presented on the modified cash basis of accounting using substantially the same modifications of the pure cash basis.
- c. All balances and transactions between the entities whose financial results are included in the consolidated financial statements should be eliminated.
- d. Any noncontrolling interests should be recognized.
- e. The consolidation policy should be disclosed.

Generally accepted accounting principles encourage the presentation of combined financial statements when entities with similar operations are commonly controlled. Commonly-controlled entities using the pure cash or modified cash basis of accounting may also present combined financial statements.

Considering Consolidation and Combination in Preparing Income Tax Basis Financial Statements. The requirement in GAAP to present consolidated financial statements does not apply to income tax basis financial statements. Generally, only C corporations can be included in a consolidated income tax return, and 80% ownership is required. If a consolidated income tax return is filed, it is a best practice for the income tax basis financial statements to present consolidated results as well since that is the basis of accounting that the entity uses to file its income tax return (which is how AU-C 800.07 and AR-C 60.07 describe the income tax basis of accounting). Accordingly, it seems like a departure from the income tax basis of accounting to present unconsolidated financial statements in that situation.

As an observation, if an entity is treated as a disregarded entity for income tax reporting, such as when the reporting entity is the sole member of a limited liability company or the sole stockholder of a qualified subchapter S subsidiary, a consolidated income tax return is not filed. Instead, the other entity is treated as if it were in substance liquidated into the reporting entity. The reporting entity files the normal return, includes the financial results of the other entity, and does not mention its existence. It is a best practice for income tax basis financial statements of the reporting entity to include the income tax basis financial results of the other entity and that separate income tax basis financial statements should not be issued for the other entity. Although the disregarded entity is included in the reporting entity's financial statements rather than issuing separate financial statements for the disregarded entity, there is nothing to preclude disclosure of information about the disregarded entity in the notes to the financial statements of the reporting entity.

Combining financial statements are designed to show combined financial results and the components of the combined financial results by member of the combined group. Therefore, this course suggests that combining income tax basis financial statements should not be presented. This differs from the conclusion in the nonauthoritative AICPA Practice Aid, which indicates that combining income tax basis financial statements may be more useful than uncombined financial statements. This course differs from the practice aid's suggestion that combining income tax basis financial statements may be presented because—

- of the definition of the income tax basis of accounting as defined in the authoritative auditing and compilation and review literature explained above;
- combining financial statements are designed to show financial results of the combined group, which is the reporting entity, and the components of the financial results by member of the combined group; and
- financial statements that show the income tax basis financial results of the members of the group and the combined income tax basis financial results cannot be considered to reflect the entity's tax return, because filing combined income tax returns is not permitted.

Although this course maintains that combined tax basis financial statements should not be presented, related-party disclosures may be necessary.

Acquiring a Controlling Financial Interest

The authoritative consolidation accounting literature in FASB ASC 810 establishes the basic requirement that financial statements should include the consolidated financial results of entities in which the reporting entity has a controlling financial interest. FASB ASC 805, *Business Combinations*, provides guidance on the initial consolidation when the reporting entity acquires a controlling financial interest in another entity.

If an entity acquires a controlling financial interest in another entity, the acquiring entity should account for the acquisition as a business combination, which generally requires measuring the assets and liabilities of the entity at their fair value and any noncontrolling financial interest in the other entity at its fair value. The amount of goodwill the acquiring entity recognizes in a business combination is generally the excess of the fair value of the consideration for the business combination over the net fair value measurements of the assets, liabilities, and noncontrolling financial interest from the business combination.

Negative goodwill arises in a business combination that is in substance a bargain purchase when the acquiring entity pays less for the net assets acquired than their fair value. Under FASB ASC 805-30-25-2, the excess of the net fair value measurements of the assets, liabilities, and noncontrolling financial interest from the business combination over the fair value of the consideration for the business combination is recognized as an ordinary gain.

The fair value measurements under FASB ASC 805 are only the initial amounts recorded for the assets, liabilities, and noncontrolling financial interest in a business combination. Going forward, those carrying amounts are subject to other measurement guidance within generally accepted accounting principles. For example, the reporting entity should initially record an identifiable intangible asset acquired in a business combination at its fair value at the date of the acquisition. After the acquisition, the asset should be accounted for following the guidance in FASB ASC 350-30-35. Accordingly, subsequent unrealized appreciation in the fair value of the asset should not be recognized, and subsequent unrealized depreciation in its fair value should be recognized only if the requirements for recognizing an impairment loss are met.

The measurement requirements of FASB ASC 805 would not be applicable to financial statements prepared on the pure cash basis of accounting. Instead, the acquisition of a controlling financial interest is only reported if a payment is made, and all payments would be recognized as disbursements. However, it seems that the measurement requirements of FASB ASC 805 would apply to modified cash basis financial statements if either the reporting entity acquired a controlling financial interest in an entity that was subsequently merged into the reporting entity or the reporting entity presents consolidated modified cash basis financial statements. The measurement requirements of FASB ASC 805 are not applicable to income tax basis financial statements, since acquisitions are accounted for in those financial statements based on tax positions taken.

In addition to measurement guidance, FASB ASC 805 also provides disclosure guidance. Some of the required disclosures are relevant only to measurements following the requirements of FASB ASC 805, but others provide more general information such as a description of the transaction. The relevant disclosure guidance in FASB ASC 805 seems to apply to financial statements prepared on the income tax, pure cash, or modified cash basis of accounting. For example, in income tax basis financial statements only the general disclosure requirements would be relevant because measurements would be determined based on the tax positions taken.

Noncontrolling Financial Interests

FASB ASC 810-10-45-16 requires a noncontrolling financial interest to be presented as a component of consolidated equity. A method for allocating consolidated earnings to the controlling and noncontrolling financial interests is not prescribed. Instead, FASB ASC 810-10-45-18 says only that the effects of eliminations can be allocated between the reporting entity and the other entity. The authoritative literature on accounting for a variable interest in a variable interest entity prescribes a method of allocating eliminations in consolidating the financial results of a variable interest entity that generally results in assigning to the controlling and noncontrolling financial interests the same earnings they would report in stand-alone financial statements.

Any reasonable method of allocating consolidated earnings to controlling and noncontrolling financial interests seems to be acceptable under generally accepted accounting principles, but the allocation method required for consolidating a variable interest entity may be preferable, even when the entity whose consolidated financial results are being included in the financial statements of the reporting entity is not a variable interest entity. When the noncontrolling financial interest has a deficiency in net assets, FASB ASC 810-10-45-21 requires the consolidated statement of financial position to report a negative balance in the equity of the noncontrolling interest.

Measurement Considerations. In consolidated income tax basis financial statements, the allocation of consolidated earnings and net assets to the controlling and noncontrolling financial interests should be the same as the allocation method used in the reporting entity's consolidated income tax return. As discussed earlier in this section, this course does not find consolidation appropriate for pure cash basis financial statements. As a practical matter, in consolidated pure cash basis financial statements, equity would consist only of cash; allocating a single asset between controlling and noncontrolling financial interests does not provide useful information. However, earnings and net assets reported in consolidated financial statements prepared on the modified cash basis of accounting should be allocated between controlling and noncontrolling financial interests. Although any reasonable allocation method may be used, as discussed above, this course recommends using the method required for consolidating a variable interest entity, even when the entity whose consolidated financial results are being included in the reporting entity's financial statements is not a variable interest entity.

Disclosure Considerations. FASB ASC 810-10-50 prescribes presentation and disclosure requirements for consolidated financial statements. Those disclosures seem relevant to consolidated financial statements prepared using the modified cash or income tax basis of accounting.

SELF-STUDY QUIZ

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

20. Which of the following entities has correctly dealt with an issue related to income taxes and financial statements prepared using the income tax basis of accounting?
- a. Bostwick Ltd. prepares its financial statements using the same measurement principles it uses to prepare its income tax return.
 - b. Carmine Consumables recognizes a full tax deduction, though it is likely it would have to settle for less with the taxing authority.
 - c. Dunaway Depot determines the amount of a tax deduction that would be accepted using only qualitative information.
 - d. Everman Enterprises discloses how the income tax basis of accounting is the same as GAAP.
21. Even when special purpose financial statements are prepared, the preparer needs to have an understanding of the related GAAP requirements. Where would a practitioner look to find the GAAP disclosure requirements for policy related disclosures?
- a. FASB ASC 740-10-50-2.
 - b. FASB ASC 740-10-50-9.
 - c. FASB ASC 740-10-50-15.
 - d. FASB ASC 740-10-50-18.
22. Which of the following would be considered a level 1 measurement on the fair value hierarchy?
- a. Measurements developed using the entity's own assumptions based on the best information available.
 - b. Measurements using quotes prices for similar assets from active markets.
 - c. Measurements using quoted prices from active markets for identical assets that the reporting entity accesses at the measurement date.
 - d. Measurements using identical assets from a market that is no longer active.
23. GAAP financial statements are required to disclose all of the following information for assets and liabilities that are measured at fair value **except**:
- a. The fair value measurements.
 - b. Whether the fair value measurements fall in level 1, 2, or 3.
 - c. A statement that unobservable inputs were used.
 - d. Information about the valuation techniques used.

24. If consolidated financial statements are prepared for an entity that uses the modified cash basis, which of the following should occur?
- a. The financial results of each entity in which the reporting entity has a controlling interest should be reported separately.
 - b. Any noncontrolling interests of the reporting entity should be recognized in the financial statements.
 - c. Balances and transactions between entities with financial results included in consolidated statements should be listed.
 - d. Certain entities should be presented using the pure cash basis and others using the modified cash basis, depending on the facts and circumstances.

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. Which of the following entities has correctly dealt with an issue related to income taxes and financial statements prepared using the income tax basis of accounting? **(Page 172)**
- a. **Bostwick Ltd. prepares its financial statements using the same measurement principles it uses to prepare its income tax return. [This answer is correct. The measurement principles used to prepare income tax basis financial statements are determined solely by the measurement principles used to prepare the income tax return. Therefore, the tax provision reported in income tax basis financial statements is the amount of income taxes reported in the income tax returns.]**
 - b. Carmine Consumables recognizes a full tax deduction, though it is likely it would have to settle for less with the taxing authority. [This answer is incorrect. If the entity believes it would likely settle with the taxing authority by agreeing to a deduction for less than the full amount originally deducted, or that the taxing authority would disallow part of the deduction, the entity should recognize a tax benefit for only the portion of the deduction expected to be ultimately accepted. Therefore, Carmine Consumables should not recognize the whole amount of the deduction.]
 - c. Dunaway Depot determines the amount of a tax deduction that would be accepted using only qualitative information. [This answer is incorrect. The amount can be determined qualitatively or quantitatively; therefore, Dunaway Depot should not ignore the option of making a qualitative assessment if that would be more accurate in its situation.]
 - d. Everman Enterprises discloses how the income tax basis of accounting is the same as GAAP. [This answer is incorrect. Financial statements prepared on the income tax basis of accounting should describe how the basis of accounting used *differs* from GAAP, not how it is the same.]
21. Even when special purpose financial statements are prepared, the preparer needs to have an understanding of the related GAAP requirements. Where would a practitioner look to find the GAAP disclosure requirements for policy related disclosures? **(Page 175)**
- a. FASB ASC 740-10-50-2. [This answer is incorrect. FASB ASC 740-10-50-2 through 50-5 and FASB ASC 740-10-50-8 discuss disclosures related to the statement of financial position.]
 - b. FASB ASC 740-10-50-9. [This answer is incorrect. FASB 740-10-9 and 50-10 cover disclosures related to the income statement.]
 - c. FASB ASC 740-10-50-15. [This answer is incorrect. The guidance in FASB ASC 740-10-50-15 covers disclosures related to unrecognized tax benefits.]
 - d. **FASB ASC 740-10-50-18. [This answer is correct. The income tax disclosure requirements for nonpublic entities are located in seven sections of FASB ASC 740-10-50. FASB ASC 740-10-50-18 through 50-20 cover policy related disclosures.]**
22. Which of the following would be considered a level 1 measurement on the fair value hierarchy? **(Page 178)**
- a. Measurements developed using the entity's own assumptions based on the best information available. [This answer is incorrect. Per the guidance in FASB ASC 820-10, this would be considered a level 3 measurement.]
 - b. Measurements using quotes prices for similar assets from active markets. [This answer is incorrect. This would be considered a level 2 measurement based on the fair value hierarchy discussed in FASB ASC 820-10.]

- c. **Measurements using quoted prices from active markets for identical assets that the reporting entity accesses at the measurement date. [This answer is correct. The fair value hierarchy outlined in FASB ASC 820-10 has three levels, generally ranging from the most objective determination of fair value to the most subjective. Level 1 is the most objective, and such measurements are made using quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.]**
- d. Measurements using identical assets from a market that is no longer active. [This answer is incorrect. This would be considered a level 2 measurement, per the fair value hierarchy discussed in FASB ASC 820-10.]
23. GAAP financial statements are required to disclose all of the following information for assets and liabilities that are measured at fair value **except: (Page 179)**
- a. The fair value measurements. [This answer is incorrect. According to the information in FASB ASC 820-10-50-2, GAAP financial statements should disclose fair value measurements.]
- b. Whether the fair value measurements fall in level 1, 2, or 3. [This answer is incorrect. Per FASB ASC 820-10-50-2, the level within the fair value hierarchy in which the fair value measurements in their entirety fall should be disclosed.]
- c. **A statement that unobservable inputs were used. [This answer is correct. The disclosure requirements for fair value measurements in a GAAP presentation are prescribed by FASB ASC 820-10-50. FASB ASC 820-10-50-1 sets the overriding objective of the disclosures about fair value measurements. FASB ASC 820-10-50-2 generally requires GAAP financial statements to disclose certain specific information for assets and liabilities measured at fair value. Those requirements include disclosure of certain information about fair value measurements using significant unobservable inputs. No such statement, however, is required as described above.]**
- d. Information about the valuation techniques used. [This answer is incorrect. Certain information about valuation techniques and inputs for fair value measurements is required to be disclosed by FASB ASC 820-10-50-2.]
24. If consolidated financial statements are prepared for an entity that uses the modified cash basis, which of the following should occur? **(Page 182)**
- a. The financial results of each entity in which the reporting entity has a controlling interest should be reported separately. [This answer is incorrect. The financial results of all entities in which the reporting entity has a controlling financial interest should be *consolidated*.]
- b. **Any noncontrolling interests of the reporting entity should be recognized in the financial statements. [This answer is correct. If consolidated financial statements are prepared for entities using the modified cash basis, any noncontrolling interests should be recognized and the consolidation policy should be disclosed.]**
- c. Balances and transactions between entities with financial results included in consolidated statements should be listed. [This answer is incorrect. Such balances and transactions between said entities should be *eliminated*.]
- d. Certain entities should be presented using the pure cash basis and others using the modified cash basis, depending on the facts and circumstances. [This answer is incorrect. The financial results of *all* consolidated entities should be presented on the modified cash basis of accounting using substantially the same modifications of the pure cash basis.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting—Course 2—Form and Style Considerations and Disclosures in Special Purpose Framework Presentations (OFSTG172)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and 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.
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EXAMINATION FOR CPE CREDIT**Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting—Course 2—Form and Style Considerations and Disclosures in Special Purpose Framework Presentations (OFSTG172)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. When should a title page be used?
 - a. In all GAAP financial statement presentations.
 - b. In all presentations that use a special purpose framework.
 - c. In all financial statement presentations, regardless of framework.
 - d. At the preparer's discretion, as needed for clarity.
2. If financial statements are bound with nonfinancial data, which of the following changes might be made to the title page?
 - a. The date would be formatted as "December 31, 2018 and 2019," instead of "Years Ended December 31, 2018 and 2019."
 - b. The title would be adapted to include the word "Consolidated" or the word "Combined."
 - c. The level of service applied to the nonfinancial data should be indicated on the title page.
 - d. A more accurate title, such as "Annual Report," might be used.
3. A useful and easily readable table of contents should do which of the following?
 - a. Include a complete heading on the table of contents page.
 - b. Refer to the complete range of pages covered by each item.
 - c. Group listed items under major section headings.
 - d. Format all entries in the table of contents in all caps.
4. What basic financial statement is presented using either account format or report format?
 - a. The statement of cash flows.
 - b. The statement of changes in partners' and proprietor's capital.
 - c. The statement of changes in stockholders' equity.
 - d. The statement of retained earnings.

5. What advice should be kept in mind when titling financial statements prepared using a special purpose framework?
 - a. The titles should be the same as those used on GAAP basis statements.
 - b. The titles can differ from those used on GAAP basis statements only if there is a specific reason and that reason is documented.
 - c. The titles should differ from GAAP basis statements so that readers do not assume the statements are presented in conformity with GAAP.
 - d. The titles need to conform to the specific special purpose statement titles outlined in the authoritative guidance.
6. In what order would the major captions be presented on the statement of cash flows?
 - a. Operating activities, investing activities, financing activities.
 - b. Operating activities, financing activities, investing activities.
 - c. Financing activities, investing activities, operating activities.
 - d. Investing activities, operating activities, financing activities.
7. When are column headings necessary?
 - a. When single-period financial statements are presented.
 - b. When the financial statements include a legend.
 - c. When the financial statements are referenced to the notes.
 - d. When comparative financial statements are presented.
8. Where are financial statement notes generally placed in a special purpose presentation?
 - a. At the bottom of each page of each statement to which they apply.
 - b. At the bottom of each financial statement to which they apply.
 - c. At the bottom of the first financial statement to which they apply.
 - d. On a separate page (or pages) after all of the basic financial statements.
9. Borris Enterprises presents its financial statements using a special purpose framework. In addition to the basic presentation, Borris Enterprises also includes key ratios and condensed summaries of the statements of revenues and expenses or assets, liabilities, and equity for five years or more in its presentation. These are an example of what type of supplementary information?
 - a. Trends information.
 - b. Details of consolidation.
 - c. Nonfinancial information.
 - d. Additional information related to line items.

10. The following entities all present financial statements prepared using a special purpose framework. Which one has correctly addressed a form and style consideration based on the recommendations provided in this course?
- a. Mac-2 uses dollar signs before each amount listed in the financial statements.
 - b. Paisley Products omits underlining for ease of readability.
 - c. Halsey Inc. rounds amounts to whole numbers.
 - d. The Ice Shoppe extends fractional percentages to the hundredth degree.
11. If special purpose financial statements have amounts that would have been disclosed under GAAP, how should those amounts be treated?
- a. The GAAP disclosure must be made.
 - b. The GAAP disclosure can be made or the substance of the requirements can be provided.
 - c. The substance of the requirements should be provided in a note to the financial statements or by using qualitative information.
 - d. Because special purpose financial statements are not based on GAAP, no disclosures required by GAAP have to be made.
12. An entity with special purpose financial statements is most likely to have which of the following financial instruments described in FASB ASC 480-10?
- a. A financial instrument that requires the entity to redeem or purchase equity shares at a specific date or as of a specific event.
 - b. A financial instrument that is considered a put option and requires settlement by the entity in cash.
 - c. A financial instrument that is mandatorily redeemable on fixed dates for fixed amounts.
 - d. A financial instrument that is considered a put option and requires settlement via the issuance of additional shares.
13. Which of the following statements best describes an aspect of how cash flows information is treated in special purpose financial statements?
- a. Cash basis financial statements often include a presentation of cash receipts and disbursements different from a GAAP statement of cash flows.
 - b. It is inappropriate for a presentation of cash receipts and disbursements to resemble a regular statement of cash flows as readers might think it was prepared under GAAP.
 - c. A statement of cash flows presented under a special purpose framework is not required to communicate the substance of or conform to GAAP requirements.
 - d. Modified cash and income tax basis statements are required to present a statement of cash flows.

14. Where would a special purpose financial statement presentation typically place its summary of significant accounting policies?
- a. On the face of the financial statements.
 - b. In the notes to the financial statements.
 - c. In the auditor's or accountant's report.
 - d. As supplementary information.
15. Which of the following occurs when derivative transactions are recorded in income tax basis financial statements?
- a. Derivatives will be adjusted to fair value if they are measured at their tax basis.
 - b. General disclosure requirements of FASB ASC 815 will likely be relevant.
 - c. GAAP requirements for estimating the fair value of derivatives will be easy and cost efficient to apply.
 - d. All the derivatives reported in the financial statements will be considered a financial instrument.
16. What type of special purpose financial statements would be most likely to make disclosures about trade receivables?
- a. Pure cash basis statements.
 - b. Modified cash basis statements.
 - c. Income tax basis statements.
 - d. Since they are not GAAP statements, no special purpose statements should make such disclosures.
17. A small or midsized company is most likely to have what type of trade receivable?
- a. Long-term financing that comes through a financial institution such as a bank.
 - b. Short-term financing that is secured by collateral.
 - c. Short-term financing provided to customers for the sale of goods and services.
 - d. Long-term financing provided to customers for the sale of goods and services.
18. Parkman Enterprises prepares its financial statements using a special purpose framework. In the current year, Parkman guaranteed debt for a related party. How will this affect Parkman's financial statements?
- a. There is no effect to the statements because special purpose financial statements do not need to make disclosures about guarantees.
 - b. There is no effect because the guarantee was to a related party and, therefore, neither measurement nor other disclosures are required to be included.
 - c. The financial statements need to disclose the nature of the guarantee and the maximum amount of undiscounted payments the company might have to make.
 - d. The financial statements will need to reflect this guarantee using the measurement guidance in FASB ASC 460-10.

19. Who is responsible for evaluating whether an entity has the ability to continue as a going concern?
- a. Management.
 - b. The accountant or auditor.
 - c. Those in charge of governance, such as the audit committee.
 - d. A third party, such as a financial institution or government office.
20. To alleviate substantial doubt about an entity's ability to continue as a going concern, management's plans to mitigate the situation must be implemented within what time frame?
- a. Six months from the end of the financial statement period.
 - b. One year from the date the financial statements were available to be issued.
 - c. Two years or before the end of the subsequent financial period.
 - d. Three years from the date the financial statements were available to be issued.
21. How obvious are going concern issues in special purpose financial statements?
- a. More obvious than in GAAP financial statements.
 - b. Less obvious than in GAAP financial statements.
 - c. Equally as obvious in special purpose statements as they would be in GAAP basis statements.
 - d. More obvious in some special purpose statements, like income tax basis, but less obvious in others, such as cash basis.
22. What is the determining factor for whether subsequent events will affect income tax basis financial statements?
- a. Tax positions taken on income tax returns.
 - b. The amount of cash recognized.
 - c. Whether the subsequent events would affect GAAP statements.
 - d. The amount of federal income taxes paid in the current year.
23. Subsequent events do **not** affect the measurements of financial statements prepared using what basis of accounting?
- a. GAAP.
 - b. The pure cash basis.
 - c. The modified cash basis.
 - d. The contractual basis.

24. Are entities required to disclose when they change from GAAP to a special purpose framework or vice versa?
- a. Yes, disclosure is required by FASB ASC 250-10.
 - b. Yes, disclosure is required by the authoritative guidance in Technical Question and Answer Q&A 9030.10 and the AICPA Practice Aid.
 - c. No, the recommendations to do so are not authoritative or required; however, it is a best practice to make the disclosure if it will be helpful to users.
 - d. No, disclosure is not required because FASB ASC 250-10 does not apply to a change in financial reporting framework.
25. Which of the following statements best describes financial statements that omit substantially all disclosures?
- a. Such financial statements need to list each of the specific omissions of which the preparer is aware.
 - b. When substantially all disclosures are omitted, the preparer can still include select disclosures that would be helpful.
 - c. If the preparer chooses to include a disclosure anyway, the disclosure must be made in the body of the financial statements.
 - d. Such financial statements will typically be longer than a full financial statement presentation.
26. An entity is presumed to have a *controlling financial interest* in another when it has which of the following?
- a. More funding than the other entity.
 - b. A longer financial history than the other entity.
 - c. A consolidated financial statement presentation with the other entity.
 - d. A majority voting equity interest in the other entity.
27. Who is considered a VIE's *primary beneficiary*?
- a. The person who has a controlling financial interest in the VIE.
 - b. The person in charge of managing the VIE.
 - c. The person who is in charge of managing the reporting entity.
 - d. The person who has been invested in the VIE for the longest length of time.
28. Are the requirements of the VIE Subsections relevant to cash and tax basis financial statements?
- a. No, the requirements of the VIE Subsections only apply to GAAP financial statements.
 - b. Not generally for pure cash and income tax basis statements, but occasionally for modified cash basis statements.
 - c. Though not relevant to income tax basis financial statements, the VIE Subsections are relevant for all cash basis statements.
 - d. Yes, the requirements of the VIE Subsections apply to both GAAP and special purpose financial statements.

29. If a reporting entity has a variable interest in a VIE but is not its primary beneficiary, disclosures may be needed to meet the following objectives. Which objective below is **not** relevant to pure cash, modified cash, or income tax basis financial statements?
- a. Significant judgments and assumptions made by the reporting entity when determining whether the entity is a VIE and if that should be disclosed.
 - b. The nature of any restrictions made on consolidated assets and liabilities of the VIE and the related carrying amounts.
 - c. The nature of any risks from the reporting entity's involvement with the VIE and any changes that affect those risks.
 - d. How involvement with the VIE may affect the reporting entity's financial position, its financial performance, and its cash flows.
30. Fairweather Ltd., the reporting entity, has a relationship with The Friendly Group that will allow Fairweather to use the accounting alternative. Fairweather presents its financial statements using the tax basis of accounting. Which of the following should Fairweather do?
- a. Omit disclosures related to the VIE Subsections.
 - b. Elect not to use the accounting alternative.
 - c. Consolidate Friendly's financial information into its own.
 - d. Take the position that GAAP does not require consolidation.
31. Which of the following is irrelevant to pure cash, modified cash, and income tax basis financial statements?
- a. Whether the entity can present a set of financial statements that omit substantially all disclosures.
 - b. Whether the VIE Subsections apply to an entity that submits special purpose financial statements.
 - c. Whether a reporting entity can present parent-entity financial statements instead of consolidated financial statements.
 - d. Whether prior-year financial statements need to be restated for a change from GAAP to a special purpose framework.
32. To recognize the benefit from a tax position, how likely must it be that the tax position will be sustained?
- a. Certain.
 - b. More likely than not.
 - c. 50/50.
 - d. Possible.

33. When would there be a difference in the tax base reported in income tax basis financial statements and GAAP financial statements?
- a. A quantitative assessment was used to determine whether a deduction would be allowed.
 - b. The likelihood of a tax position being accepted is less than 50%.
 - c. The tax position meets the probability amount outlined in FASB ASC 740-10-25-6.
 - d. The entity chose to recognize the smallest amount of the allowable tax benefit.
34. Use of the modified cash basis would be most appropriate for which of the following entities?
- a. The Sweet Shoppe is oriented toward cash receipts and disbursements.
 - b. Baker's Dozen uses modifications that make its statements, in essence, GAAP statements.
 - c. Kale Ltd.'s operations are influenced significantly by financing sales.
 - d. Whammy Inc.'s operations require complex modifications related to manufacturing.
35. Which of the following would be considered appropriate when pure or modified cash financial statements have income tax uncertainties?
- a. Modifying the pure cash basis to recognize an asset/liability on the income tax basis.
 - b. Modifying the pure cash basis to recognize current income tax assets/liabilities without considering FASB ASC 740-10.
 - c. Reporting income taxes as an amount paid or received during the period when using the pure cash basis.
 - d. Recognizing assets for overpayments of income taxes and liabilities for income taxes due.
36. What is one condition under which the disclosure requirements of FASB ASC 740-10-50-15 and 50-19 should be considered?
- a. The entity in question is large.
 - b. The entity in question has material unrecognized tax benefits.
 - c. The entity's tax positions all meet the appropriate likelihood criteria.
 - d. The entity could be charged interest and penalties if the tax position is rejected.
37. Red Windmills Inc. (RWI) collects taxes from its customers and sends those amounts to the taxing authority. Which of the following will occur?
- a. RWI will need to present these amounts in its statement of cash flows.
 - b. RWI's financial statements will only be affected if this is related to inventory procurement.
 - c. RWI needs to disclose significant amounts of taxes by type (i.e., sales) if they are presented gross.
 - d. The wording for any related disclosures will differ in special purpose statements from that in GAAP statements.

38. Which of the following statements best describes an aspect of the fair value option offered by FASB ASC 825-10?
- a. Aside from a few exclusions, this option can be used for all financial assets and liabilities.
 - b. If the fair value option is elected, the entity is relieved of any disclosure requirements related to fair value.
 - c. Because liabilities are recorded, pure cash basis financial statements are affected by the fair value option.
 - d. If income tax basis statements elect the fair value option, its requirements for income tax reporting will be affected.
39. How are the rules for consolidating financial statements affected when the financial statements are prepared using the income tax basis of accounting?
- a. The GAAP requirements for presenting consolidated financial statements apply equally to tax basis financial statements.
 - b. Typically, only S corporations are allowed to be included in a consolidated income tax return and related statements.
 - c. A minimum of 60% ownership is required for a corporation to be included in a consolidated income tax return and related statements.
 - d. If a consolidated tax return is filed by an entity, typically it is best for the entity to consolidate the income tax basis financial statements, as well.
40. A noncontrolling financial interest must be presented as which of the following?
- a. A component of consolidated equity.
 - b. A variable interest entity.
 - c. A business combination.
 - d. A change in accounting principle.

GLOSSARY

Account format: A format for the statement of change in stockholders' equity in which the accounts that comprise stockholders' equity are listed across the top of the statement and changes in each account are presented in columnar form and explained by captions to the left of the columns.

Accounting change: A *change in accounting principle*, a change in an accounting estimate, or a change in the reporting entity.

Cash basis: A basis of accounting used by the reporting entity to record cash receipts and disbursements. It includes modifications of the cash basis having substantial support, commonly known as the *modified cash basis*. When there are no such modifications, it is called the *pure cash basis*.

Change in accounting principle: This 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.

Contractual basis: A basis of accounting used by the entity to comply with an agreement between the entity and one or more third parties other than that practitioners.

Current assets: These include cash and other assets that are reasonably expected to be realized in cash or sold or consumed during one year or within the company's normal *operating cycle* if longer than a year.

Current liabilities: Obligations that will be liquidated by using *current assets* or creating other current liabilities. They include (1) noncurrent obligations that, by their terms, are due on demand or will be due on demand within one year (or *operating cycle*, if longer) from the statement of assets, liabilities, and equity date, even if their liquidation is not expected within that period; and (2) noncurrent obligations that are callable by the creditor because (a) the debtor is in violation of a provision of the debt agreement at the statement of assets, liabilities, and equity date or (b) a violation has occurred at the statement of assets, liability, and equity date that, if not cured within a specified grace period, will make the obligation callable.

Financial asset: A financial instrument that conveys a right to the entity.

Financial liability: A contract that imposes an obligation on the entity.

Financial report: The entire package that typically incorporates the financial statements. For special purpose framework presentations, the package generally includes many, if not all, of the following: (1) title (or cover) page, (2) table of contents, (3) accountant's or auditor's report, (4) basic financial statements and notes, and (5) other financial or supplementary information.

Financial statement notes: These notes are used to present material disclosures not otherwise presented in the financial statements. They are considered an integral part of the financial statements and, as such, are the responsibility of the client.

Member in business: An accountant who is employed by, under contract to, or volunteers for an entity. Such accountants lack independence and would never issue an accountant's or auditor's report.

Nonrecognized subsequent events: These subsequent events provide information that does not indicate that an asset was impaired or a liability was incurred at the end of the reporting period (because the subsequent event occurred after the end of the reporting period) but may require disclosure so the financial statements will not be misleading.

Open tax year: A tax year that is subject to examination by major tax jurisdictions.

Operating cycle: This is the time needed for an entity to convert cash first into materials and services, then into products, then by sale into receivables, and finally by collection back into cash.

Other basis: A basis of accounting utilizing a definite set of logical and reasonable criteria that is applied to all material items within the financial statements.

Primary beneficiary: The party that has a controlling financial interest in a VIE. To have this status, the entity must have a *variable interest* in the VIE along with both of the following characteristics: (1) the power to direct the activities of the VIE that most significantly impact the economic performance of the VIE and (2) either the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

Reasonable period of time: According to SAS No. 132, this is the period required by the applicable financial reporting framework, or, if no such period is designated, one year from the date the financial statements are available to be issued.

Recognized subsequent events: These subsequent events provide additional information about whether an asset was impaired or a liability was incurred at the end of the reporting period. This information should be considered in determining the carrying amount of the asset or liability at the end of the reporting period.

Regulatory basis: A basis of accounting used by the reporting entity to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject.

Report format: A format for the statement of change in stockholders' equity in which individual statements for each stockholders' equity account are used to present the changes.

Special purpose framework: Bases of accounting other than GAAP. In practice, special purpose frameworks may also be referred to as other comprehensive bases of accounting (OCBOAs).

Tax basis: A basis of accounting the reporting entity uses to file its tax return for the period covered by the financial statements.

Tax position: A position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods.

Variable interest: This is a contractual, ownership, or other pecuniary interest in the entity that changes with fluctuation in the fair value of the entity's net assets.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET**Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting—Course 1—Other Bases of Accounting, Reporting on Special Purpose Framework Financial Statements, and Interim Engagements (OFSTG171)**

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a	b	c	d	a	b	c	d	a	b	c	d	a	b	c	d
1. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	11. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	21. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	31. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
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9. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	19. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	29. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	39. <input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
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Expiration Date: November 30, 2018

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting—Course 1—Other Bases of Accounting, Reporting on Special Purpose Framework Financial Statements, and Interim Engagements

Course Acronym: OFSTG171

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:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. How would you rate the examination related to the course material?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
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4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

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:

- What did you find **most** helpful? _____
- What did you find **least** helpful? _____
- What other courses or subject areas would you like for us to offer? _____
- Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
- How many employees are in your company? _____
- 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 Cash, Tax, and Other Bases of Accounting—Course 2—Form and Style Considerations and Disclosures in Special Purpose Framework Presentations (OFSTG172)**

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