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Companion to PPC's Guide to

Compilation and Review Engagements

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Interactive Self-study CPE

Companion to PPC's Guide to Compilation and Review Engagements

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INTRODUCTION

Companion to PPC's Guide to Compilation and Review Engagements consists of three interactive self-study CPE courses. These are companion courses to *PPC's Guide to Compilation and Review Engagements* designed by our editors to enhance your understanding of the latest issues in the field. *PPC's Compilation and Review Engagements* and other PPC products are available for purchase at **tax.tr.com/ppcguidance**.

To obtain credit for this course, you must complete the learning process by logging on to our Online Grading System at **cl.tr.com/ogs** or by emailing, faxing, or mailing your completed **Examination for CPE Credit Answer Sheet** for print grading by **July 31, 2022**. Complete instructions for grading are included below and in the test instructions preceding the **Examination for CPE Credit**.

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Each course is divided into lessons. Each lesson addresses an aspect of compilation and review engagements. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reasoning 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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Checkpoint Learning is also approved for "QAS Self Study" designation.

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

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

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Online Grading. Log onto our Online Grading Center at **cl.tr.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam of $109 is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the test instructions preceding the **Examination for CPE Credit**. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

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You may fax your completed **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation** to **(888) 286-9070** or email them to *CPLGrading@thomsonreuters.com*. The mailing address is provided on the each course's overview page and on the instructions preceding each exam.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet**. Payment must accompany each answer sheet submitted ($109 when sent by email or fax; $119 when sent by regular mail). We would also appreciate a separate **Self-study Course Evaluation** from each person who completes an examination.

Retaining CPE Records

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 COMPILATION AND REVIEW ENGAGEMENTS

COURSE 1

FORM AND PRESENTATION OF FINANCIAL STATEMENTS, PARTNERSHIPS, AND S CORPORATIONS (CARTG211)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course takes a look at several issues related to compilation and review engagements. Lesson 1 discusses the form and presentation of financial statements. Lesson 2 examines issues related to partnerships. Lesson 3 concludes the course with a discussion of issues related to S corporations.
PUBLICATION/REVISION DATE:	July 2021
RECOMMENDED FOR:	Users of *PPC's Guide to Compilation and Review Engagements*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of accounting
CPE CREDIT:	7 NASBA Registry "QAS Self-Study" Hours
	This course is designed to meet the requirements of the Statement on Standards of Continuing Professional Education (CPE) Programs (the Standards), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the Standards in their entirety. For states that have adopted the Standards, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.
FIELD OF STUDY:	Accounting
EXPIRATION DATE:	Postmark by **July 31, 2022**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Form and Presentation of Financial Statements

Completion of this lesson will enable you to:

- Identify the title page, TOC, accountant's report, and the basic financial statements in a typical GAAP presentation.
- Recognize the correct presentation of significant accounting policies and notes.
- Identify proper presentation of supplementary information, risks and uncertainties, derivatives, accounts receivable, fiscal year changes, and uncertain tax positions.
- Determine practices for combinations, consolidations, controlling interests, and fair value measurements.

Lesson 2—Partnerships

Completion of this lesson will enable you to:

- Determine proper reporting for various partnership issues such as accounting basis, partner loans, partner capital, investments, and changes in legal form.
- Identify accounting and reporting issues of LLCs and LLPs.

Lesson 3—S Corporations

Completion of this lesson will enable you to:

- Recognize appropriate presentation for S corporations and retained earnings.
- Identify losses, tax/book differences, and termination of a retained earnings account.

TO COMPLETE THIS LEARNING PROCESS:

Log onto our Online Grading Center at **cl.tr.com/ogs**. Online grading allows you to get instant CPE credit for your exam.

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

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

  Thomson Reuters
  Tax & Accounting—Checkpoint Learning
  CARTG211 Self-study CPE
  36786 Treasury Center
  Chicago, IL 60694-6700

See the test instructions included with the course materials for additional instructions and payment information.

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Lesson 1: Form and Presentation of Financial Statements

INTRODUCTION

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

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

a. Title Page

b. Table of Contents

c. Accountant's Report

d. Basic Financial Statements

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

f. Notes to Financial Statements

g. Supplementary or Other Information

Before proceeding to the general discussions that follow, it is important to note that preparing financial statements is both an art and a science, normally learned by trial and error or by word of mouth, but never completely mastered. It is an art in that financial statements must be presented in a format that has eye appeal, is understandable, conveys a company's financial picture, and can be produced economically. It is a science in that it requires the mastery of a complex array of authoritative standards for measurement, presentation, and disclosure. The subject matter will be addressed in general terms in this lesson. Accordingly, accountants may wish to supplement the guidance in this lesson with the comprehensive guidance found in *PPC's Guide to Preparing Financial Statements*.

For consistency, the authors have adopted the financial statement formats and style policies in this lesson from *PPC's Guide to Preparing Financial Statements*.

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

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the title page, TOC, accountant's report, and the basic financial statements in a typical GAAP presentation.
- Recognize the correct presentation of significant accounting policies and notes.
- Identify proper presentation of supplementary information, risks and uncertainties, derivatives, accounts receivable, fiscal year changes, and uncertain tax positions.
- Determine practices for combinations, consolidations, controlling interests, and fair value measurements.

THE TITLE PAGE

General

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

XYZ CORPORATION

FINANCIAL STATEMENTS

Years Ended December 31, 20X2 and 20X1

Name of Company

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

a. ABC CORPORATION

b. XYZ LTD.

c. JONES NURSERY

d. THE ESTATE OF JOHN DOE

e. MR. AND MRS. JOHN Q. PUBLIC

f. JANE DOE TESTAMENTARY TRUST

Title of Financial Statements

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

BALANCE SHEET or STATEMENT OF INCOME

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

a. CONSOLIDATED FINANCIAL STATEMENTS

b. COMBINED BALANCE SHEET

c. CONSOLIDATED STATEMENT OF INCOME AND RETAINED EARNINGS

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

BALANCE SHEETS or STATEMENTS OF INCOME

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

FINANCIAL STATEMENTS AND SUPPLEMENTARY
(OR OTHER FINANCIAL) INFORMATION

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

XYZ CORPORATION

COMPILED FINANCIAL STATEMENTS

Years Ended December 31, 20X2 and 20X1

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

Date or Period Covered

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

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

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

c. Six Months Ended June 30, 20X2

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

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

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

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

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

b. Entities using 13-week quarters:

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

c. Initial financial statements for new entities:

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

d. Financial statements for liquidating entities:

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

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

December 31, 20X2 and 20X1

Different Levels of Service—Comparative Financial Statements

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

XYZ CORPORATION

FINANCIAL STATEMENTS

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

THE TABLE OF CONTENTS

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

THE PRESENTATION OF THE ACCOUNTANT'S REPORT

General

This lesson does not discuss the wording of the accountant's compilation or review report or other considerations that affect the degree of responsibility assumed by the accountant as the scope of this lesson focuses on presentation and format. Information about the content of these reports is available in *PPC's Guide to Compilation and Review Engagements*. *PPC's Guide to Auditor's Reports* discusses and illustrates auditor's reports. This section discusses presentation and format considerations for the accountant's report. The next section begins a discussion of referencing to the accountant's report.

Letterhead

There is no requirement that the accountant's report be printed on the firm's letterhead (nor is there any SSARS requirement that the accountant's report be manually signed or that the financial statements be bound). Consequently, the report can be presented on plain stationery without letterhead. However, the authors believe that it is generally preferable for the accountant's report to be presented on the firm's letterhead. The use of letterhead adds the formality that reflects the professional approach to association with financial statements. Accountants may use software packages that generate the appropriate accountant's report, which may be difficult to print on firm letterhead. In these situations, the accountant can enhance the professional appearance of the product by binding the software-generated statements and report in report covers containing the firm name and logo. Alternatively, the accountant may take the system-generated report and photocopy it onto the firm's letterhead if it is difficult to have the system print the report directly onto the firm's letterhead. Note also that if the firm letterhead used for printing the accountant's report indicates the city and state of the office issuing the accountant's report, the requirement at AR-C 80.A26 (AR-C 80A.A26) and AR-C 90.A120 (AR-C 90A.A78) to include that information is met.

Title of Accountant's Report

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

AR-C 90.76 (AR-C 90A.39) a requires the accountant's review report to include a title that clearly indicates that it is the accountant's review report and includes the word *independent*. An appropriate title would be—

INDEPENDENT ACCOUNTANT'S REVIEW REPORT

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

Address

The SSARS [AR-C 80 (AR-C 80A)] does not contain a requirement for compilation reports to include an addressee, but does for review reports [AR-C 90.76b (AR-C 90A.39b)]. However, nothing precludes an accountant from including an addressee in a SSARS compilation report, if so desired. Generally, the accountant's report is addressed

to management, but may be addressed to the Board of Directors or Stockholders. Reports are not intended as letters. Accordingly, addresses that include street names and zip codes are not appropriate. Many firms also omit the city and state in the address, especially when the report is addressed to stockholders who are widely dispersed. Examples of appropriate addresses follow:

a. To Management
   XYZ Corporation
   Philadelphia, Pennsylvania

b. To the Stockholders
   XYZ Corporation

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

a. Closely held company:

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

b. Personal financial statements:

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

c. Partnerships:

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

   or

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

d. Proprietorship financial statements:

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

e. Trust financial statements:

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

f. Estate financial statements:

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

Salutations

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

Signature

AR-C 80.17g (AR-C 80A.17g) requires that compilation reports contain a signature of the accounting firm or the accountant, as appropriate. AR-C 90.76h (AR-C 90A.39g) also requires that review reports contain a signature of the accounting firm or the accountant, as appropriate. SSARS No. 23 removed the application guidance concerning signing the accountant's compilation report and thus the SSARS are silent on how the report may be signed. The authors believe that the signature placed on a compilation or review report can be manual, printed, or digital.

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

Reference to Office Location

AR-C 80.17h (AR-C 80A.17h) and AR-C 90.76i (AR-C 90A.39h) require the accountant's compilation and review reports to name the city and state where the accountant practices. There is no requirement regarding the placement of the city and state on the report. The illustrative reports in the SSARS show the city and state after the signature of the accountant or accounting firm and before the date of the accountant's report. In addition, AR-C 80.A26 (AR-C 80A.A26) and AR-C 90.A120 (AR-C 90A.A78) note that the city and state may be included in the letterhead of the report.

Date of Report

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

a. March 3, 20X2

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

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

Midland, Texas
March 31, 20X2

Periods Covered

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

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

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

BASIC GAAP FINANCIAL STATEMENTS

What Are They?

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

a. Balance Sheet.

b. Statement of Income.

c. Statement of Comprehensive Income.

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

e. Statement of Cash Flows.

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

Comparative Financial Statements

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

Heading Financial Statements

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

Reference to Accountant's Report

The SSARS do not have a requirement for a reference to the accountant's report to be included on each page of the financial statements. However, AR-C 80.A24 (AR-C 80A.A24) and AR-C 90.A108 (AR-C 90A.A67) both indicate that the accountant may consider including a reference such as "See accountant's compilation report," "See independent accountant's compilation report," or " See independent accountant's review report" on each page of the financial statements in order to avoid an unintended level of reliance on the financial statements if the compilation or review report were to become unattached from the statements.

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

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

> See accompanying notes and accountant's report.

Reference to the notes could also be added to the more specific references discussed above. Although the reference to accompanying notes is not required by the SSARS, the authors believe that it is a common practice for accountants to include such a reference if the financial statements include notes. However, because there is not a requirement to include a reference to the accountant's report or to the notes, the financial statements illustrated throughout this course do not illustrate such references.

Legend for Prepared Financial Statements

AR-C 70 (AR-C 70A) 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 (AR-C 70A.14) requires each page of the financial statements to include a statement indicating no assurance has been provided on the financial statements. The authors believe this will most commonly be done with the use of a legend with wording such as "No assurance is provided on these financial statements."

Use of "Unaudited"

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

Different Levels of Service

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

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

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

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

or

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

Disclosure in the column headings would be as follows:

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

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

THE BALANCE SHEET

Balance Sheet Title

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

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

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

Balance Sheet Format

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

Classification (Current/Noncurrent)

A *classified* balance sheet distinguishes current assets and current liabilities from other assets and liabilities. In general, separate disclosure of the significant components of financial statements is presumed to make them more useful. Separate disclosure of the components of working capital (current assets less current liabilities) is presumed to be useful in the financial statements of manufacturing, trading, and some service entities. However, in some industries, e.g., savings and loan associations and real estate, an unclassified balance sheet is accepted practice because the working capital distinction is not relevant. The authors recommend presenting a classified balance sheet unless an industry accounting or audit guide specifically permits an unclassified presentation or an unclassified balance sheet is industry practice.

Criteria for Classification. The criteria for separating current and noncurrent items are specified by FASB ASC 210-10-45-1 through 45-12; 310-10-45-9, and are summarized as follows:

- *Current Assets.* 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. (Current assets normally include cash, marketable securities, receivables, inventories, and prepaid expenses.)
- *Current Liabilities.* Obligations whose liquidation is reasonably expected to require the use of current assets or the creation of other current liabilities. (Current liabilities include short-term obligations such as payables for materials and supplies, wages, taxes, amounts collected in advance of delivery of goods or performance of services, the current portion of long-term obligations, and any other obligations expected to be liquidated within a year.)
- *Operating Cycle.* 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 or 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.

Classification of Debt. If a classified balance sheet is presented, long-term loan agreements need to be analyzed to determine appropriate classification as either a current or long-term liability. In January 2017, the FASB issued a

proposed ASU, *Debt (Topic 470): Simplifying the Classification of Debt in a Classified Balance Sheet (Current versus Noncurrent)*, which would have significantly revised the requirements for classifying debt as current versus noncurrent. In March 2019, the FASB announced they would be issuing a revised exposure draft of the proposed amendments. The proposal would continue to allow debt with covenant violations to be classified as noncurrent if a waiver meeting certain conditions is received before the financial statements are available to be issued. However, during recent deliberations, a majority of FASB members concluded that the proposed amendments would not achieve the objective of the project nor reduce the cost and complexity of compliance. Therefore, the project was removed from the FASB's technical agenda.

THE INCOME STATEMENT

Title of Statement of Income

Alternative titles for presentation of an income statement include:

a. Statement of Income.

b. Income Statement.

c. Statement of Earnings.

d. Statement of Operations.

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

Income Statement Format

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

Revenue and Expense Recognition

Revenue and Expense Recognition Prior to the Implementation of FASB ASC 606. Prior to the implementation of FASB ASC 606, generally the standards for recognition of revenues and expenses may be stated as follows:

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

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

Those statements provide a reasonable general description. However, in the authoritative accounting standards prior to the issuance of ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and related amendments, and in accepted industry practice, there are many variations and refinements.

Revenue and Expense Recognition after Implementation of FASB ASC 606. FASB ASC 606 provides a comprehensive, principles-based framework for recognizing revenue, which supersedes FASB ASC 605 and virtually all industry-specific revenue guidance in the Codification. For nonpublic companies, FASB ASC 606 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual reporting periods beginning after December 15, 2019. However, in June 2020, the FASB issued ASU 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, to defer the effective dates of implementing FASB ASC 606 for certain entities. Entities that have not yet issued (or made available for issuance) financial statements may now implement FASB ASC 606 for annual reporting periods

beginning after December 15, 2019 and interim reporting periods in annual reporting periods beginning after December 15, 2020.

Generally, after the implementation of FASB ASC 606, the standards for recognition of revenues and expenses may be stated as follows:

a. Revenue should be recognized when the entity satisfies a performance obligation by transferring a promised good or service to a customer.

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

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

PRESENTING COMPREHENSIVE INCOME

FASB ASC 220, *Income Statement—Comprehensive Income*, requires comprehensive income and its components to be reported when a company presents a full set of financial statements that report financial position, results of operations, and cash flows. The ASC establishes standards for reporting and presenting comprehensive income and its components in a basic set of financial statements. The following paragraphs provide a definition of comprehensive income and a brief discussion of certain related classification and presentation issues. Further guidance regarding presentation and disclosure issues concerning comprehensive income may be found in *PPC's Guide to Preparing Financial Statements*.

Definition of Comprehensive Income

Comprehensive income includes both net income and other comprehensive income (i.e., certain revenues, expenses, gains, and losses that are reported as separate components of stockholder's equity rather than in net income). Under FASB ASC 220-10-45-10A, other comprehensive income includes:

- unrealized gains and losses on debt securities classified as available-for-sale.
- amounts recognized in other comprehensive income for debt securities classified as available-for-sale and held-to-maturity related to an other-than-temporary impairment.
- gains or losses related to pension or other postretirement benefits.
- prior service costs or credits related to pension or other postretirement benefits.
- transition assets or obligations related to pension or other postretirement benefits.
- foreign currency translation adjustments and gains and losses from certain foreign currency transactions.
- (for derivatives designated in a qualifying hedging relationship) the difference between (1) the change in the fair value of an excluded component in the assessment of hedge effectiveness and (2) the initial value of that component recognized in income over the life of the hedging instrument.

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

Presentation of Comprehensive Income

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

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

FASB ASC 220-10-45-12A allows entities to reclassify the amounts in accumulated other comprehensive income to retained earnings related to the income tax effects of the Tax Cuts and Jobs Act (TCJA), also referred to as the *stranded tax effects* of the TCJA. If an entity chooses to reclassify the stranded tax effects out of accumulated comprehensive income, it must disclose that it has elected to do so and provide a description of the effects of the TCJA that are reclassified to retained earnings. If an entity chooses not to reclassify the stranded tax effects, it must disclose that a reclassification was not made. A thorough discussion of the TCJA is beyond the scope of this course. For more information on the TCJA, refer to Thomson Reuters's Checkpoint "Complete Analysis of the Tax Cuts and Jobs Act" and "Special Study Highlights of the Tax Cuts and Jobs Act."

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

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

a. the components that make up net income,

b. a total for net income,

c. the components of other comprehensive income,

d. a total for other comprehensive income, and

e. a total for comprehensive income.

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

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

REVENUES		$ 8,924,000
COSTS AND EXPENSES		
Cost of goods sold	$ 3,185,000	
Selling, general, and administrative expenses	2,283,000	5,468,000
OTHER INCOME		
Gain on sale of securities (includes $50,000 reclassification from accumulated other comprehensive income for previously unrealized gains on debt securities)		54,500
INCOME BEFORE INCOME TAXES		3,510,500
INCOME TAXES (includes $20,000 for reclassification adjustment from unrealized gains on debt securities)		1,404,200
CONSOLIDATED NET INCOME		2,106,300
LESS: NET INCOME ATTRIBUTABLE TO THE NONCONTROLLING INTEREST		421,260
NET INCOME ATTRIBUTABLE TO ABC COMPANY SHAREHOLDERS		1,685,040
OTHER COMPREHENSIVE INCOME, NET OF TAX		
Foreign currency translation adjustments		60,000
Unrealized gains on debt securities		
Unrealized holding gains arising during the period	150,000	
Less: reclassification adjustment for gains included in net income	(30,000)	120,000
Defined benefit pension plans		
Prior service cost arising during the period	(12,000)	
Net loss arising during the period	(9,000)	
Less: amortization of prior service cost included in net periodic pension cost	6,000	(15,000)
OTHER COMPREHENSIVE INCOME		165,000
TOTAL COMPREHENSIVE INCOME		2,271,300
LESS: COMPREHENSIVE INCOME ATTRIBUTABLE TO THE NON-CONTROLLING INTEREST		454,260
COMPREHENSIVE INCOME ATTRIBUTABLE TO ABC COMPANY SHAREHOLDERS		$ 1,817,040

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

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

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

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

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

a. the components of other comprehensive income,

b. a total for other comprehensive income, and

c. a total for comprehensive income.

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

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

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

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

SELF-STUDY QUIZ

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

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

    a. BAKER'S DOZEN, C CORPORATION.

    b. BALANCE SHEET AND OTHER FINANCIAL STATEMENTS.

    c. Years Ended December 31, 20X3 and 20X2.

    d. (These statements have been audited.)

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

    a. Presentation generally includes five statements plus policies and notes as applicable.

    b. Statistical information and detailed schedules must be included as required supplementary information.

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

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

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

    a. Balance sheet.

    b. Statement of Income.

    c. Statement of changes in stockholders' equity.

    d. Statement of cash flows.

SELF-STUDY ANSWERS

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

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

   a. BAKER'S DOZEN, C CORPORATION. [This answer is incorrect. The name of the company should be presented exactly as listed in the charter, partnership agreement, or other appropriate legal document. When the company is not a regular corporation, the type of legal entity should be disclosed. Since Baker's Dozen *is* a C corporation, it does not need to disclose the type of entity.]

   b. BALANCE SHEET AND OTHER FINANCIAL STATEMENTS. [This answer is incorrect. If the presentation includes more than one type of financial statement, the term *Financial Statements* is the most practical method of communicating to the reader what is included in the presentation. Therefore, in this scenario, only FINANCIAL STATEMENTS would be needed on Baker's Dozen's title page.]

   c. **Years Ended December 31, 20X3 and 20X2. [This answer is correct. When both a balance sheet and statement of income are presented, the period covered by the statement (or statements) of income should be shown on the title page. Appropriate examples include "Years Ended December 31, 20X3 and 20X2" and "Six Months Ended June 30, 20X3." Therefore, this presentation of the date on the title page would be correct.]**

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

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

   a. **Presentation generally includes five statements plus policies and notes as applicable. [This answer is correct. The basic financial statements included in a typical GAAP financial statement presentation are (1) balance sheet, (2) statement of income, (3) statement of comprehensive income, (4) statement of retained earnings or changes in stockholders' equity, and (5) statement of cash flows. The typical presentation also includes descriptions of accounting policies and notes to the financial statements.]**

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

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

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

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

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

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

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

d. Statement of cash flows. [This answer is incorrect. GAAP does not specify a title for the statement of cash flows. However, FASB ASC 230, *Statement of Cash Flows*, generally refers to the statement as the "Statement of Cash Flows." However, no matter what title it uses, the statement of cash flows is a different basic financial statement than the one to which a "Statement of Operations" title would apply.]

THE STATEMENTS OF RETAINED EARNINGS OR CHANGES IN STOCKHOLDERS' EQUITY

General

In most situations, unless the client has debt or equity securities accounted for under FASB ASC 320-10, FASB ASC 321-10, and 942-320, the only stockholders' equity account to change during the period covered by the statements of a nonissuer will be the retained earnings account. Generally, a combined statement of income and retained earnings is the best way to disclose changes in retained earnings. Alternatively, the authors believe the change in retained earnings may be disclosed adequately on the face of the balance sheet. Many computer-prepared financial statements, for example, present retained earnings on the balance sheet in two segments—Prior or Beginning Retained Earnings and Current Year-to-date Earnings. This adequately discloses the change in retained earnings especially when earnings represent the only change. In other circumstances, the type of changes or number of changes will sometimes necessitate a separate statement of retained earnings. Changes, if any, in other stockholder equity accounts must also be disclosed. Disclosure of these changes may be made in a note to the financial statements or may be presented in a separate Statement of Changes in Stockholders' Equity. Illustrations presenting changes in stockholder equity accounts are presented in the following paragraphs.

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

Combined Statement of Income and Retained Earnings

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

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

	20X2	20X1
REVENUE	$ 35,337,000	$ 32,785,000
COST AND EXPENSES		
Cost of products sold	21,780,000	20,530,000
Selling and administration	7,032,000	6,525,000
Interest on long-term debt	891,000	910,000
Miscellaneous	244,000	215,000
	29,947,000	28,180,000
INCOME BEFORE INCOME TAXES	5,390,000	4,605,000

	20X2	20X1
INCOME TAXES		
Current	2,000,000	2,000,000
Deferred	600,000	290,000
	2,600,000	2,290,000
NET INCOME	2,790,000	2,315,000
RETAINED EARNINGS AT BEGINNING OF YEAR	12,172,000	10,783,000
Cash dividends on common stock (20X2—$.75 per share; 20X1—$.50 per share)	(1,395,000)	(926,000)
RETAINED EARNINGS AT END OF YEAR	$ 13,567,000	$ 12,172,000

See accompanying notes.

Restatement of Retained Earnings

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

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

See accompanying notes.

Separate Statement of Retained Earnings

A separate statement of retained earnings might appear as follows:

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

	20X2	20X1
RETAINED EARNINGS AT BEGINNING OF YEAR	$ 1,586,000	$ 1,380,000
Net income	875,000	511,000
Dividends		
In cash		
On preferred stock ($3.50 a share)	(105,000)	(105,000)
On common stock (20X2—$1.25 a share; 20X1—$1.00 a share)	(250,000)	(200,000)

	20X2	20X1
In stock		
Fair value of 10,000 shares of common stock issued as stock dividend—5%	(374,000)	—
RETAINED EARNINGS AT END OF YEAR	$ 1,732,000	$ 1,586,000

See accompanying notes.

Statement of Changes in Stockholders' Equity—Comparative Statements Presented

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

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

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

	20X2	20X1
COMMON STOCK IN TREASURY		
Balance at beginning of year	$ —	$ —
Purchase of 30,000 shares for treasury	(450,000)	—
BALANCE AT END OF YEAR	$ (450,000)	$ -0-
TOTAL STOCKHOLDERS' EQUITY	$ 21,500,000	$ 20,140,000

See accompanying notes.

Statement of Changes in Stockholders' Equity—Single Year Statement

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

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

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

See accompanying notes.

Negative Equity

If liabilities exceed assets, a negative equity balance will be reported. The authors believe the term *equity* should not be used in those situations and instead recommend using the following captions:

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

THE STATEMENT OF CASH FLOWS

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

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

How Cash Is Defined

A statement of cash flows shows the change in cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents during the period. Cash and cash equivalents are defined as shown in Exhibit 1-1. GAAP does not include a definition of restricted cash or restricted cash equivalents. Restricted cash and restricted cash equivalents are restricted as to use. Examples include amounts pledged as collateral under debt agreements, refundable deposits, minimum balances on bank accounts, or self-insurance funding arrangements.

Exhibit 1-1

GAAP Definitions

CASH	CASH EQUIVALENTS
Definition (FASB ASC 230-10-20)	*Definition* (FASB ASC 230-10-20)
. . . cash includes not only currency on hand but demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty	. . . short-term, highly liquid investments that (a) are readily convertible to known amounts of cash and (b) are so near to their maturity that they present insignificant risk of changes in value because of changes in interest rates.
Examples—Certificates of deposit,[a] money market accounts, and repurchase agreements that have the characteristics described above.	*Examples*—Treasury bills, commercial paper, money market accounts that are not classified as cash, and other short-term investments with original maturities of three months or less.[b] (Note that equity securities never meet the definition of cash equivalents.)

Notes:

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

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

Throughout this lesson, the authors use the term *cash* to include *cash equivalents* and *restricted cash* to include *restricted cash equivalents*.

Basic Elements

A statement of cash flows has five basic elements:

a. Cash flows from operating activities.

b. Cash flows from investing activities.

c. Cash flows from financing activities.

d. Net change in cash during the period.

e. Supplemental disclosure of noncash investing and financing activities.

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

Types of Cash Flows. Exhibit 1-2 shows how a typical company's transactions would be classified into operating, investing, and financing activities according to the GAAP criteria (not all inclusive).

Exhibit 1-2

Types of Cash Flows

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

STATEMENT OF CASH FLOWS			NONCASH INVESTING AND FINANCING TRANSACTIONS
OPERATING	INVESTING	FINANCING	
• Operating lease payments[a], including variable and short-term lease payments not included in the lease liability • Other cash payments not related to investing or financing activities, such as cash contributions and cash refunds to customers			

Note:

[a] After implementation of FASB ASC 842, operating lease payments related to bringing the asset to the necessary condition and location are included in investing activities.

Gross and Net Cash Flows

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

a. Investing Activities

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

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

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

b. Financing Activities

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

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

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

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

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

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

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

   (1) Deposits placed with other financial institutions

   (2) Customer time deposits

   (3) Loans made to customers

Presentation Considerations

Cash flow statements should report the total amounts of cash, cash equivalents, restricted cash, and restricted cash equivalents at the beginning and end of the period, and those amounts should be the same as similarly titled line items or subtotals in the balance sheet as of those dates. In other words, the net change in cash during the period should be added to cash at the beginning of the period to obtain cash at the end of the period.

Beginning and ending cash must also include restricted cash and equivalents. Cash, cash equivalents, restricted cash, and restricted cash equivalents that are presented in more than one line on the statement of financial position are required to be presented on the face of the statement of cash flows *or* disclosed in the notes to the financial statements. The presentation, whether on the face of the cash flow statement or in the notes, should allow the users of the financial statements to identify or reconcile the amounts in the statement of financial position that are included in the total cash, cash equivalents, restricted cash, and restricted cash equivalents in the statement of cash flows. This information must be presented for all periods included in the financial statements. In addition, the nature of any restrictions on cash and cash equivalents should be disclosed. While most preparers follow the ending cash format, they may revise the format of the statement to begin with "cash at beginning of year."

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

Order of Presentation. The order for presenting operating, investing, and financing activities in statements of cash flows is not addressed in GAAP; however, the authors believe virtually all companies will report cash flows from operations first. The authors' preference is to follow the format used in the illustrations included in FASB ASC 230-10-55 and show investing activities following operations and to present financing activities last. It is acceptable, however, to present financing activities before investing activities.

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

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

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

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

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

Cash Flows from Operating Activities

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

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

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

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

Exhibit 1-2 lists some typical examples of cash flows from operating activities.

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

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

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

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

b. Interest and dividends received.

c. Other operating cash receipts, if any.

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

e. Interest paid, including cash paid to settle (1) zero-coupon debt instruments that is attributable to the accreted interest pertaining to the debt discount or (2) other debt instruments that have coupon interest rates that are insignificant compared to the borrowing's effective interest rate that is attributable to the accreted interest pertaining to the debt discount.

f. Income taxes paid.

g. Other operating cash payments, if any.

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

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

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

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

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

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

Net Cash Flows from Operating Activities	$ 298,100

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

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

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

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

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

Noncash entries to current operating assets and liabilities generally should be presented as separate adjustments to net income in arriving at cash flows from operations. Common examples of noncash transactions affecting current operating assets and liabilities include recording a provision for bad debts and providing a reserve for inventory

obsolescence. To illustrate, assume that a company's activities relating to trade accounts receivable are summarized as follows:

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

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

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

If noncash entries are not material, however, the authors believe it is appropriate to present only the net change in current assets and liabilities.

Cash Flows from Investing Activities

Investing activities include the following:

a. Lending money and collecting on loans.

b. Acquiring and selling or disposing of securities.

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

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

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

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

Cash Flows from Financing Activities

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

- Obtaining resources from owners and providing them with a return on, and a return of, their investment.
- Borrowing money and repaying the amounts borrowed or otherwise settling the obligation.

- Obtaining and paying for other resources from creditors on long-term credit.
- Receiving resources from donors with use stipulated for long-term purposes.

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

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

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

Noncash Investing and Financing Activities

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

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

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

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

CASH FLOWS FROM OPERATING ACTIVITIES	
Net income	$ 66,200
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation	7,200
Increase in receivables	(10,000)
Decrease in inventory	2,000
Decrease in payables	(4,400)
NET CASH PROVIDED BY OPERATING ACTIVITIES	61,000

CASH FLOWS USED BY INVESTING ACTIVITIES	
Purchase of equipment	(30,000)
CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds of long-term borrowings	25,000
Repayment of long-term borrowings	(5,000)
NET CASH PROVIDED BY FINANCING ACTIVITIES	20,000
NET INCREASE IN CASH	51,000
CASH AT BEGINNING OF YEAR	75,000
CASH AT END OF YEAR	$ 126,000
SUPPLEMENTAL DISCLOSURES	
Noncash Investing and Financing Transactions:	
Debt obligation incurred for use of equipment	$ 15,600

THE SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

When Is It Required?

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

What Must Be Included?

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

a. A selection from existing acceptable alternatives.

b. Industry peculiarities.

c. Unusual or innovative applications of GAAP.

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

- *Inventories*—the basis for stating inventories and the method of determining cost (FASB ASC 210-10-50-1).
- *Depreciation*—a general description of the methods used in computing depreciation for major classes of depreciable assets (FASB ASC 360-10-50-1).
- *Cash Equivalents*—the policy used to determine which short-term investments are treated as cash equivalents in the statement of cash flows (FASB ASC 230-10-50-1).

- *Debt Securities*—the basis on which the cost of a debt security sold or the amount reclassified out of accumulated other comprehensive income into earnings was determined (FASB ASC 320-10-50-9) and the policy for requiring collateral or other security for repurchase agreements or securities lending transactions (FASB ASC 860-30-50-1A).
- *Notes Receivable or Loans*—the policy for accounting for loan and trade receivables including determination of allowances, charge offs, recognizing interest income, treatment of related fees, and how cash receipts are recorded (FASB ASC 310-10-50-2, 50-4A, and 50-15).
- *Advertising*—the policy used for reporting advertising (i.e., whether costs are expensed as incurred or when the advertising first takes place) except for direct response advertising costs (FASB ASC 720-35-25-1).
- *Sales and Similar Taxes*—the policy regarding the presentation of sales and similar taxes (e.g., use, value added, and certain excise taxes), that is, whether such taxes are presented on a gross or net basis (FASB ASC 606-10-32-2A).
- *Shipping and Handling Costs*—the policy for classifying shipping and handling costs. For example, whether such costs are included in cost of sales (FASB ASC 606-10-25-18B).
- *Interest and Penalties*—the policy for classifying interest, as income taxes or interest expense, and penalties, as income taxes or another expense (FASB ASC 740-10-50-19).

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

- Recognition of revenue from contracts with customers.
- Basis of consolidation.
- Revenue recognition from leasing operations.
- Amortization of intangibles.

Recommended Accounting Policy Disclosures

As mentioned above, GAAP requires disclosure of all significant accounting policies. In addition to disclosures required by specific pronouncements, the authors recommend disclosing the accounting methods prescribed by authoritative literature that are relatively complex such as the following:

- *Investments in Debt and Equity Securities*—describe the accounting treatment of unrealized gains and losses.
- *Deferred Income Taxes*—briefly describe how current and deferred taxes are calculated.
- *Investments at Equity*—disclose the lag if the investee's year end differs from the investor's year end. FASB ASC 323-10-35-6 recognizes that investees may not have the same year end as the investor and states that "a lag in reporting should be consistent from period to period." The authors recommend that the lag not exceed three months, which is consistent with GAAP for consolidations.
- *Derivatives*—describe the accounting treatment of gains and losses related to fair value, cash flow, or foreign currency hedges.

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

- Goodwill amortization on a straight-line basis over a maximum of 10 years.
- Cash flow hedge accounting practical expedients for qualifying receive-variable, pay-fixed interest rate swaps.
- Exemption from the consolidation requirements of the variable interest entities guidance in FASB ASC 810-10 for certain legal entities under common control.
- Recognition of fewer intangible assets separate from goodwill in a business combination.

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

> The Company has adopted the accounting alternative offered to private companies in FASB ASC 810-10 for certain legal entities under common control. In accordance with this alternative, the Company does not apply the variable interest entities guidance in FASB ASC 810-10 to nonpublic legal entities under common control. Instead, the Company discloses information required by the accounting alternative, including the nature, risks, and maximum exposure to loss associated with the Company's involvement with the legal entity under common control. See Note H.

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

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

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

> Beginning in 20X4, the Company adopted the accounting alternative offered to nonpublic entities for the subsequent measurement of goodwill. In accordance with this alternative, the Company amortizes goodwill over 10 years on the straight-line basis and only evaluates goodwill for impairment at the entity level when a triggering event occurs.

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

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

Manner of Disclosure

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

Other Disclosures

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

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

THE NOTES TO FINANCIAL STATEMENTS

General

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

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

Format

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

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

Title

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

ABC CORPORATION
NOTES TO FINANCIAL STATEMENTS
December 31, 20X2

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

ABC CORPORATION
NOTES TO BALANCE SHEET
December 31, 20X2

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

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

Content (Disclosure Checklists)

The notes should include disclosures required by the applicable financial reporting framework that are not presented on the face of the statements or in the summary of significant accounting policies. In addition, the accountant should keep in mind that the financial statements should include all information necessary to prevent them from being misleading regardless of whether the disclosure is specifically required by accounting pronouncements. A listing of all possible required disclosures is not practical; however, the accountant may want to refer to a disclosure checklist for GAAP disclosure requirements for financial statements of a nonpublic company organized for profit.

Referencing Accounting Standards in the Notes

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

SELF-STUDY QUIZ

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

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

    a. Treasury bills.

    b. Commercial paper.

    c. Investments that mature in over three months.

    d. Certificates of deposit.

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

    a. Cash payments for operating.

    b. Cash payments for investing.

    c. Cash payments for financing.

    d. Noncash investing and financing transactions.

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

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

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

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

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

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

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

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

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

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

SELF-STUDY ANSWERS

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

4. In addition to currency an entity has on hand, which of the following would be considered *cash*? **(Page 26)**

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

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

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

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

5. Paisley Products pays dividends to its stockholders. How would this be classified on its statement of cash flows? **(Page 27)**

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

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

    c. **Cash payments for financing. [This answer is correct. A statement of cash flows has five basic elements: (1) cash flows from operating activities, (2) cash flows from investing activities, (3) cash flows from financing activities, (4) net change in cash during the period, and (5) supplemental disclosure of noncash investing and financing activities. Examples of cash payments for financing include dividends, repayment of amounts borrowed, and Treasury stock.]**

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

6. Which of the following is considered part of the cash flows from operating activities? **(Page 31)**

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

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

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

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

7. Which of the following statements best describes the summary of significant accounting policies? **(Page 36)**

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

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

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

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

INCLUDING SUPPLEMENTARY OR OTHER INFORMATION

General

The unaudited financial statements of a nonpublic entity often include statistical information, detailed schedules, summaries, or comparisons, that are not part of the basic financial statements. This supplementary information, which is not required for a fair presentation in accordance with the applicable financial reporting framework, is often useful to the owners or management and, in some cases, is prepared especially for creditors. As mentioned earlier, information required by the applicable financial reporting framework should be presented on the face of the financial statements or in the notes. Supplemental schedules should *not* be used to present information required by the applicable financial reporting framework such as future minimum lease payments and five-year maturities of long-term debt. Forecasts or projections that accompany historical financial statements are normally not considered supplementary or other information. *PPC's Guide to Forecasts and Projections* discusses the accountant's responsibility for such information. However, budgets for an expired period of time are not prospective data, i.e., they are considered supplementary information and should be reported on in accordance with AR-C 80.34–.36 (AR-C 80A.34–.36) and AR-C 90.126–.128 (AR-C 90A.83–.85).

Content

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

a. Budgets for an expired period.
b. Cost of goods sold schedule.
c. Manufacturing expense schedule.
d. Selling expenses.
e. General and administrative expenses.
f. Details of marketable securities.
g. Property and equipment schedule.
h. Condensed historical financial statements.
i. Aging analysis of accounts receivable.
j. Department earnings statements.
k. Details of consolidation.
l. Organizational data (history, etc.).
m. Comparative statements expressed in percentages.
n. Details of sales by product line, territory, or salesman.

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

a. Rates of inventory turnover.
b. Days of sales in accounts receivable.
c. Gross profit comparisons.

Presentation

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

SUPPLEMENTARY INFORMATION

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

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

Reporting

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

Percentages

In the authors' opinion, percentages presented on the statement of income (as is commonly the case with computer-prepared statements) do not constitute supplementary information for purposes of the reporting requirements applicable to supplementary information.

Charts and Graphs

The unaudited financial statements of a nonissuer sometimes include financial information presented in the form of a chart or graph. The authors believe such information should ordinarily be considered supplementary information.

Details of Consolidation or Combination

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

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

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

Schedule Headings

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

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

Reference to Report

While the SSARS has no requirement for a reference to the accountant's report, some accountants believe that each supplementary schedule should include a reference to the accountant's report. AR-C 80.A47 (AR-C 80A.A43) and AR-C 90.A200 (AR-C 90A.A144) both state that the accountant may choose to include a reference to the accountant's report on each page of the supplementary information in order to avoid any inadvertent reliance on the supplementary information if the accountant's report were to become detached. For example, some accountants may choose to include the reference when reviewed financial statements are accompanied by supplementary schedules which are not subjected to the accountant's review procedures, as the level of service provided on the supplementary schedules is lower than that provided on the basic financial statements. An appropriate reference when the accountant's report on the supplementary information is part of the report on the basic financial statements would be—

> See accountant's report.

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

> See accountant's report on supplementary information.

DEALING WITH RISKS AND UNCERTAINTIES

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

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

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

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

Scope and Applicability

The disclosure requirements apply regardless of an entity's size and also apply to interim financial statements. They are not required in condensed or summarized interim financial statements. FASB ASC 275-10-15-4 explicitly excludes certain risks and uncertainties from the disclosure requirements. These include risks and uncertainties that might be associated with the following:

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

- War.
- Sudden catastrophes.

The following paragraphs provide a brief overview of the four areas of disclosure required by FASB ASC 275-10-50. Additional guidance and case studies on applying FASB ASC 275-10-50 are found in *PPC's Guide to Preparing Financial Statements*.

Nature of Operations

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

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

Use of Estimates

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

Certain Significant Estimates

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

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

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

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

- *Probable.* The future event or events are likely to occur.
- *Reasonably Possible.* The chance of the future event or events occurring is more than remote but less than likely.
- *Remote.* The chance of the future event or events occurring is slight.

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

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

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

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

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

Estimates to Which the Disclosure Requirement Applies. The types of estimates that should be considered for disclosure are those used in the determination of the carrying amounts of assets or liabilities or in the disclosure of gain or loss contingencies. In other words, the disclosure requirements relate to estimates used to determine (a) recorded amounts and (b) disclosures of gain or loss contingencies. Disclosure should generally be considered more closely when a condition, situation, or set of circumstances makes an estimate more susceptible to change than it ordinarily would be. In addition, the more critical an estimate is to the financial statements, the more likely it is that disclosure is needed. As a practical matter, the disclosure can be used to provide an early warning to financial statement users that certain estimates, based on the best information available, are still somewhat soft and changes in them may affect future financial statements.

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

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

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

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

Current Vulnerability Due to Concentrations

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

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

Certain of these concentrations are already disclosed in some financial statements. One example is economic dependence on major customers or suppliers. While there has been some disagreement as to whether economic

dependence disclosures are still required for nonissuers, GAAP requires them in all financial statements (if the criteria for disclosure listed below are met). Another example is disclosure of concentrations of credit risk. Although concentrations of financial instruments are specifically excluded from the disclosure requirements, disclosure of market or customer concentrations may also provide the necessary disclosure for credit risk concentrations.

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

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

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

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

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

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

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

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

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

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

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

Exhibit 1-3

Disclosing Significant Risks and Uncertainties

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

Wording the Disclosures. Applying the disclosure requirements requires significant judgement on the part of both the accountant and the client. However, there are only disclosure requirements. It does not require amounts to be recorded in the financial statements. For that reason, an approach of "when in doubt, disclose" is generally recommended. In a sense, by making the disclosure, the client, as well as the accountant, transfers some of the risk

due to uncertainties in the financial statements to the financial statements users themselves. By not making the disclosures, however, the client and the accountant forego an opportunity to reduce the risk that a user may successfully assert in litigation that the disclosures should have been made.

Going Concern Uncertainty

FASB ASC 205-40 provides guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related disclosure requirements. The key features of FASB ASC 205-40 are as follows:

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

According to the definition at AR-C 90.08 AR-C 90A.05, a *reasonable period of time* is the period of time required by the applicable financial reporting framework, or if there is not a requirement, one year from the date the financial statements are issued or are available to be issued. AR-C 90.A11 (AR-C 90A.A10) indicates that most financial reporting frameworks requiring management to evaluate the entity's ability to continue as a going concern specify the period of time to be evaluated. For example, as discussed in the previous paragraph, FASB ASC 205-40 indicates a reasonable period of time is within one year after the date that financial statements are issued (or available to be issued). AR-C 90 (AR-C 90A) also contains going concern application guidance with examples of conditions or events that may indicate a going concern and illustrative emphasis of matter language that may be used if there is an uncertainty about the entity's ability to continue as a going concern. AR-C 80.15 (AR-C 80A.15) indicates that if the accountant becomes aware that the financial statements are misleading, he or she should propose revisions to management. An undisclosed uncertainty about the entity's ability to continue as a going concern is listed in AR-C 80.A20 (AR-C 80A.A20) as an example of misleading financial statements. If such a situation exists, the accountant may suggest additional disclosures be made.

GENERAL GUIDANCE FOR DERIVATIVE INSTRUMENTS

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

What Is a Derivative?

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

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

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

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

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

Accounting for Derivatives

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

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

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

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

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

Disclosure Requirements

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

Common Uses of Derivatives

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

CONSIDERATIONS FOR ACCOUNTS RECEIVABLE

Presentation and Disclosure Considerations for Receivables

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

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

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

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

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

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

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

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

      (a) The method used for recognizing interest income.

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

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

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

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

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

   (1) Deferred fees or costs.

   (2) Discount from imputing interest.

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

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

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

   (1) Deferred fees and costs.

   (2) Deferred gross profit.

   (3) Discount from imputing interest.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Accounting Policies for Trade Receivables and Credit Losses and Doubtful Accounts. The authors believe the policies ordinarily can be disclosed through a relatively standard note in the summary of significant accounting policies, such as—

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

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

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

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

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

As another example—

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

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

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

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

> NOTE X—CHANGES IN THE VALUATION ALLOWANCE FOR TRADE ACCOUNTS RECEIVABLE
>
> Changes in the valuation allowance for trade accounts receivable are—

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

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

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

RECENT STANDARDS RELATED TO LEASING

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which among other things, requires the recognition of lease assets and lease liabilities by lessees, including for those leases classified as operating leases under previous GAAP, along with the disclosure of key information about leasing arrangements. When effective, the ASU will supersede FASB ASC 840, *Leases*, and add Topic 842, *Leases*, to the FASB ASC. In addition to replacing FASB ASC 840 with FASB ASC 842, the ASU amends and supersedes a number of other Topics throughout the FASB ASC. Subsequent to the issuance of ASU 2016-02, the FASB issued the following ASUs that address additional matters and improvements to guidance in FASB ASC 842:

a. ASU 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842* (January 2018)

b. ASU 2018-10, *Codification Improvements to Topic 842, Leases* (July 2018)

c. ASU 2018-11, *Leases (Topic 842): Targeted Improvements* (July 2018)

d. ASU 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors* (December 2018)

e. ASU 2019-01, *Leases (Topic 842): Codification Improvements* (March 2019)

f. ASU 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates* (November 2019)

g. ASU 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities* (June 2020)

The following paragraphs discuss certain elements of the new leasing guidance.

Lessee Accounting

Lessees are required to classify a lease as a *finance lease* if certain criteria are met as of the lease commencement date. These criteria are similar to those for capital leases to current GAAP. Otherwise, the lease should be categorized as an *operating lease*. Unless the lessee elects an accounting policy for certain short-term leases, a right-of-use asset and a lease liability should be recognized as of the lease commencement date.

For finance leases, after the commencement date, the lessee recognizes the following expenses for each period: (a) amortization expense for the right-of-use-asset and interest expense related to the lease liability; (b) variable lease payments incurred in the period, which were not included in the lease liability; and (c) impairment expense, if appropriate, related to the right-of-use asset. The amortization of the right-of-use asset should be calculated on a straight-line basis, unless another systematic basis is more representative of the pattern of benefits received from the asset.

For operating leases, after the commencement date, the following expenses are recognized in each period after the commencement date: (a) unless the right-of-use asset is impaired, lease expense representing the straight-line (or

other more representative basis) allocation of the remaining cost of the lease over the remaining lease term; (b) variable lease payments incurred in the period, which were not included in the lease liability; and (c) impairment expense, if appropriate, related to the right-of-use asset.

A lessee may elect as an accounting policy, by class of underlying asset, to not recognize a right-of-use asset and lease liability for a short-term lease. A short-term lease is a lease that has a term of 12 months or less as of the commencement date and does not have a purchase option that the lessee is reasonably certain to exercise. If this policy is elected, the lease payments should be expensed on a straight-line basis over the lease term. Variable lease payments should be recognized in the period that the obligation is incurred.

Lessor accounting

For lessors, if a lease meets any of the criteria that results in a finance lease for a lessee, it is classified as a *sales-type lease*. Otherwise, it should be classified as an *operating lease* unless the present value of the lease payments and guaranteed residual value is equal to or exceeds substantially all of the fair value of the leased asset. If so, and if the collection of the lease payments and guaranteed residual value are probable, the lease is classified as a *direct financing lease*. Lessor accounting under ASU 2016-02 is substantially unchanged from current leasing standards. The vast majority of operating leases should continue to be classified as operating leases. However, ASU 2016-02 makes specific changes to matters such as certain glossary terms. In addition, certain aspects of the lessor accounting model have been aligned with the revenue recognition guidance introduced by ASU 2014-09, *Revenue from Contracts with Customers (Topic 606).*

Other

Among other things, FASB ASC 842 also provides guidance on sale and leaseback transactions. Also, leveraged lease classification and accounting is eliminated by FASB ASC 842 for new leases that commence after the effective date of ASU 2016-02. However, lessors will continue to account for leveraged leases that commenced prior to the effective date of the new standard using current GAAP.

Effective Date

The ASU, as amended by ASU 2019-10, was to be effective for nonpublic business entities for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021, with early adoption permitted. However, citing challenges relating to the COVID-19 pandemic, in June 2020, the FASB issued ASU 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities* to defer the effective date of ASU 2016-02, as amended, until fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Users should refer to ASU 2016-02 and the subsequent related ASUs for additional information about specific transition and disclosure amendments and requirements. Users may download the ASUs from the FASB's website at **www.fasb.org** or from Checkpoint at **checkpoint.riag.com**. *PPC's Guide to Preparing Financial Statements* provides additional detail on the amendments in ASU 2016-02 and subsequent related ASUs. Due to the delayed effective dates of ASU 2016-02, this course has not been fully updated for the requirements of the ASU.

WHEN COMPANIES CHANGE FISCAL YEAR

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

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

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

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

	December 31, 20X2	June 30, 20X2

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

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

The following illustrates disclosing the change in the notes:

NOTE B—FISCAL YEAR CHANGE

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

UNCERTAINTIES RELATED TO TAX POSITIONS

Accounting for Uncertainty in Income Taxes

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

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

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

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

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

b. has no temporary differences;

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

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

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

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

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

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

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

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

The following illustrates the disclosure FASB ASC 740-10 would require for the reporting entity described in the above list.

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

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

However, disclosure of interest and penalties as line items in the financial statements also discloses the entity's presentation policy.

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

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

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

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

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

REPORTING ON BUSINESS COMBINATIONS, CONSOLIDATIONS, AND CONTROLLING FINANCIAL INTERESTS

A reporting entity may be required to include financial results of another entity in its financial statements. That requirement generally depends on the level of influence the reporting entity has over the other entity:

a. The reporting entity should consolidate the financial results of the other entity if it has a *controlling financial interest* in the other entity.

b. The reporting entity should recognize its share of the earnings of the other entity (that is, use the equity method) if it does not have a controlling financial interest in the entity but has an equity interest that gives it *the ability to exercise significant influence* over the operating and financial policies of the other entity.

If a person or entity has a controlling financial interest in the reporting entity and a controlling financial interest in one or more other entities, combined financial statements may be presented for the reporting entity and some or all of the other entities that are commonly controlled.

The Reporting Entity

Conceptually, the reporting entity is the entity or entities whose financial results are reported in the financial statements. In consolidated financial statements, the reporting entity is the group of entities whose financial results are consolidated. FASB ASC 260-10-20 refers to that group as the *consolidated group*, which it defines as the "parent and all its subsidiaries." Similarly, in combined financial statements, from a conceptual standpoint, the reporting entity is the group of entities whose financial results are combined. Although not addressed in the Codification, the authors refer to that group as the *combined group*. If the financial statements are not consolidated or combined, the reporting entity is a single entity.

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Definition of a Business

ASU 2017-01, *Clarifying the Definition of a Business*, which amends the definition of a business in FASB ASC 805, was issued to assist entities in determining whether a transaction should be accounted for as a business combination or an acquisition of an asset. For nonpublic entities, ASU 2017-01 is effective for years beginning after December 15, 2018, and interim periods within years beginning after December 15, 2019.

FASB ASC 805-10-55-3A, which was added by ASU 2017-01, defines a business as an integrated set of activities and assets that is capable of being carried out and managed to provide a return (e.g., dividends, lowered costs, or other economic benefits) directly to the owners (e.g., investors, members, stockholders). At a minimum, FASB ASC 805-10-55-5 indicates a business must have two elements, an input and a substantive process, which generally contribute to the creation of an output. Those elements are defined as follows:

- *Inputs*. Economic resources that create or can contribute to the creation of outputs from the application of one or more processes.
- *Processes*. Systems, standards, protocols, conventions, or rules that are applied to inputs to create or provide the ability to contribute to the creation of an output.
- *Outputs*. Goods or services provided to customers, investment income, and other revenues that result from the application of processes to inputs.

Control, Controlling Interest, and Noncontrolling Interest

Whether consolidation is required generally depends on whether the reporting entity has a controlling financial interest in another entity, and determining if a business combination has occurred generally depends on whether the reporting entity has acquired a controlling financial interest. GAAP sometimes uses the term *control* when referring to a controlling financial interest. For example, FASB ASC 805-10-20 defines *acquirer* as the "entity that obtains control of the acquiree" and, FASB ASC 805-50-15-6 provides guidance on accounting for transactions between entities under common control. FASB ASC 805-10-20 states "control has the meaning of controlling financial interest in paragraph 810-10-15-8."

GAAP does not prescribe a term that must be used in consolidated financial statements to describe a controlling financial interest. For example, FASB ASC 810-10-50-1A requires consolidated financial statements to disclose the amounts of consolidated net income attributable to the parent and the noncontrolling interest. However, it does not require that the term *parent* be used. The illustrative financial statement in FASB ASC 810-10-55-4I discloses that information using two captions—*Entity ABC shareholders' equity* and *noncontrolling interest*. The authors believe it would have been acceptable to substitute the caption *controlling interest* or *controlling financial interest* for *Entity ABC shareholders' equity* and that it also would have been acceptable to name the noncontrolling interest.

FASB ASC 220-10-20 defines *noncontrolling interest* as—

> the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

While use of the term *minority interest* is not prohibited, the authors believe the term *noncontrolling interest* is preferable.

Accounting for Intangible Assets in a Business Combination

FASB ASC 805-20 provides an accounting alternative to simplify accounting for certain identifiable intangible assets acquired in business combinations by private companies. A private company that elects the accounting alternative to recognize or otherwise consider the fair value of intangible assets as a result of any business combinations should not recognize separately from goodwill (a) customer-related intangible assets unless they are capable of being sold or licensed independently from the other assets of the business and (b) noncompete agreements. Entities electing this accounting treatment would generally recognize fewer identifiable intangible assets than under current GAAP. An entity that makes this election must also elect the private company alternative to amortize goodwill as described in FASB ASC 350-20-35-62.

PPC's Guide to Preparing Financial Statements includes a more complete discussion of business combinations, consolidations, and controlling financial interests.

Including the Financial Results of Another Entity in the Financial Statements of the Reporting Entity

The reporting entity should consolidate the financial results of another entity if it has a controlling financial interest in the entity. The reporting entity should recognize its share of the earnings of another entity (that is, use the equity method) if it does not have a controlling financial interest in the entity but has an equity interest that gives it the ability to exercise significant influence over the operating and financial policies of the entity.

SELF-STUDY QUIZ

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

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

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

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

    c. The effect of the concentration would have a material impact on the entity.

    d. It is remotely possible that events causing a severe impact will occur.

9. Which of the following is the most common use for derivatives?

    a. When an entity wishes to use book value to report assets and liabilities.

    b. When an entity is required to take physical delivery of an asset.

    c. Helping smaller entities obtain loan agreements.

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

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

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

    b. Amounts due from affiliates must always be included in current assets.

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

    d. Credit risk for trade receivables must be disclosed on an aggregate basis.

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

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

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

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

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

SELF-STUDY ANSWERS

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

8. Assuming all other criteria are met, when would a concentration need to be disclosed in the financial statements? **(Page 49)**

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

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

    c. The effect of the concentration would have a material impact on the entity. [This answer is incorrect. FASB ASC 275-10-20 specifies that the impact would need to be severe for disclosure to be required. A severe impact is a higher threshold than material, so there is a better answer to this question.]

    d. It is remotely possible that events causing a severe impact will occur. [This answer is incorrect. For a concentration to require disclosure, one criterion that must be met is that it is at least reasonably possible (not remotely possible) that the events that could cause the severe impact will occur in the near term.]

9. Which of the following is the most common use for derivatives? **(Page 52)**

    a. When an entity wishes to use book value to report assets and liabilities. [This answer is incorrect. According to FASB ASC 815, all entities are required to measure derivative instruments at fair value and recognize them as either assets or liabilities on the balance sheet. Book value does not apply to derivatives.]

    b. When an entity is required to take physical delivery of an asset. [This answer is incorrect. According to FASB 815, a derivative instrument may allow net settlement; it can readily be settled net by a method outside the contract; *or* it provides for delivery of an asset. The entity is not necessarily required to take physical delivery of the asset. Derivatives have a more common use.]

    c. Helping smaller entities obtain loan agreements. [This answer is incorrect. A derivative instrument may be embedded in another contract, such as a loan or lease agreement. However, the presence of a derivative does not necessarily aid an entity in obtaining a loan. There is a more common use for derivatives.]

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

10. Which of the following presentation and disclosure considerations applies to an entity's receivables? **(Page 53)**

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

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

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

d. Credit risk for trade receivables must be disclosed on an aggregate basis. [This answer is incorrect. GAAP requires disclosures about credit risk considerations for trade receivables on a disaggregated (not aggregate) basis. FASB ASC 310-10-50 requires disclosures by portfolio segment and by class of financing receivable.]

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

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

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

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

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

THE NEED TO CONSOLIDATE A VARIABLE INTEREST ENTITY

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

An Accounting Alternative for Common Related Party Leasing Arrangements

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

An Overview of the Accounting Alternative. The accounting alternative is narrow, providing only an *optional* exemption of a defined related party leasing arrangement from the scope of the VIE Subsections. (This accounting alternative allows nonpublic entities to adopt the accounting alternative for the first time without justifying that it is preferable. Any subsequent changes in accounting policy after adoption of the accounting alternative require that preferability be assessed.) The accounting alternative is available for a related party leasing arrangement with the following characteristics:

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

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

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

The VIE Subsections provide a list of relationships (included in the list below) that generally indicate a variable interest entity relationship exists. If the relationships listed do not exist, the guidance does not need to be considered. Additionally, according to FASB ASC 810-10-15-17AB, with the accounting alternative, even if one or more of the relationships listed do exist, the VIE guidance does not need to be considered for a relationship that has the characteristics in the previous paragraph. For example, if the lessor entity was formed by the reporting entity and its related parties (condition a. in the below list), consideration of the VIE guidance is not required if the relationship between the reporting entity and the lessor entity has the characteristics listed in the previous paragraph.

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

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

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

A small or midsize nonpublic entity should consider whether it has a variable interest in a variable interest entity if it has one of the following relationships with another entity (FASB ASC 810-10-15-17d):

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

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

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

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

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

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

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

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

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

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

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

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

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

A reporting entity also does not need to consider including in its financial statements the consolidated financial results of some types of entities. A reporting entity does not need to consider whether an employee benefit plan is a variable interest entity. In addition, a reporting entity would generally not need to consider whether a not-for-profit entity is a variable interest entity unless the reporting entity uses a not-for-profit entity in a manner similar to a variable interest entity. The authors believe small and midsize nonpublic entities rarely use a not-for-profit entity in

that manner. Any not-for-profit entity with which they have a relationship is likely a charitable organization, and the measurement requirements of GAAP for VIEs would not apply to the relationship.

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

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

Some Notions Underlying the Remaining Considerations

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

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

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

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

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

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

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

that exist at the time the entity is formed but instead is made based on the assumption that future losses and benefits would be significant.

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

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

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

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

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

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

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

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

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

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

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

Whether equity is sufficient depends on the facts and circumstances and the authors believe sufficiency should be assessed qualitatively. Examples follow for an entity that is formed through debt and equity.

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

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

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

a. the goals in forming the entity,

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

c. the party that in substance controls those activities.

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

An individual who holds the majority voting equity interest in an operating entity decides to form a separate entity to acquire real estate and lease it to the operating entity The rental entity financed 80% of the cost of acquiring the property. The individual's primary financial goals in acquiring the property through a separate entity rather than through the operating entity were to give her a direct stream of cash flows through rentals and through the ultimate sale of the property.

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

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

Determining Whether the Other Entity is a Variable Interest Entity

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

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

b. Its equity investors do not have—

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

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

   (3) the right to receive its benefits.

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

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

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

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

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

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

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

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

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

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

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

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

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

a. If the entity is determined to be a variable interest entity, the reporting entity would consider the remaining requirements of the authoritative literature on accounting for a variable interest in a variable interest entity to determine whether it is required to include in its financial statements the consolidated financial results of the entity. If the remaining considerations in the authoritative literature on accounting for a variable interest

in a variable interest entity lead the reporting entity to conclude that consolidation is not required, the reporting entity is not required to then consider the general requirements of the authoritative consolidation accounting literature.

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

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

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

Determining Whether Consolidation is Required

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

a. An individual may be the primary beneficiary.

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

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

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

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

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

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

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

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

As amended by ASU 2015-02, if the reporting entity does not have both characteristics of a primary beneficiary listed above, the reporting entity should consider the involvement of related parties. That is done by following one of two paths: the *shared power path* or the *single decision maker path* as discussed in the following paragraphs.

Specifically, following the *single decision maker path*, the reporting entity considers the following:

a. If the reporting entity is the single decision maker, it considers whether, on a direct and indirect basis, it bears the risk of losses, or has the right to receive benefits, that could potentially be significant to the VIE. For purposes if this determination, the reporting entity should include all of its direct variable interests in the entity and its indirect variable interests, on a proportionate basis, held through related parties. If so, it is the primary beneficiary.

b. If the criteria in item a. are not met, the reporting entity considers whether it and all of its related parties as a group meet both characteristics of a primary beneficiary. If the related party group meets both characteristics, a further determination is made whether one or more of the related parties are under common control with the single decision maker and the commonly controlled group meets both characteristics.

c. If the criteria in item b. are met, the reporting entity considers whether one of the related parties, other than the reporting entity, has both the power to direct the activities of the VIE that most significantly impact its economic performance *and either* bears the risk of losses, *or* has the right to receive benefits, that could potentially be significant to the VIE. If so, that related party is the primary beneficiary. If not, the most closely associated test is performed.

The reporting entity follows the *shared power path* if, instead of having a single decision maker, the power characteristic is shared among related parties. In that case, the reporting entity considers whether it and all of its related parties as a group meet both characteristics of a primary beneficiary. If the related party group meets both characteristics, the most closely associated test is performed. If not, the reporting entity is not the primary beneficiary.

After following the above guidance, if the related-party group has both characteristics of a primary beneficiary, the reporting entity should determine whether it is the member of the group most closely associated with the variable interest entity. If the reporting entity is the most closely associated member, it should include the consolidated financial results of the variable interest entity in its financial statements. If it is not the most closely associated member, the reporting entity should not include the consolidated financial results of the variable interest entity in its financial statements.

Per FASB ASC 810-10-25-44, the determination of whether the reporting entity is the party in the related-party group most closely associated with the variable interest entity should be made based on assessments of all relevant facts and circumstances, including—

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

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

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

d. the design of the variable interest entity.

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

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

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

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

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

What Is the Design of the Lessor? A VIE may be designed to give a certain entity the power to direct its most significant activities or to create and pass certain significant risks and rewards to a particular variable interest holder. For example, the typical related-party leasing arrangement is designed to give the individual control of the property, which provides evidence that the individual is more closely associated with the lessor than the lessee is.

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

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

PRESENTING CONSOLIDATED, CONSOLIDATING, AND COMBINED FINANCIAL STATEMENTS

Consolidated and Consolidating Financial Statements

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

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

Column A—Parent company's financial statements

Column B—Subsidiary #1's financial statements

Column C—Subsidiary #2's financial statements

Column D—Consolidating entries

Column E—Consolidated totals

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

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

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

Reporting Implications of Consolidating Financial Statements

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

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

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

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

Combined Financial Statements

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

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

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

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

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

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

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

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

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

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

a. The entities are under common control.

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

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

Combined Financial Statement Style and Format Considerations

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

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

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

or

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

or

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

or

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

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

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

CONSIDERATIONS FOR FAIR VALUE MEASUREMENTS

The Definition of Fair Value

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

The Assets or Liabilities

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

The Price

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

The Market

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

Market Participants

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

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

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

c. Able to conduct the transaction.

d. Willing to conduct the transaction.

Asset Valuation Considerations

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

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

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

Liability Valuation Considerations

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

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

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

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

Relevant observable inputs should be used to the maximum extent possible and the overall objective of fair value measurement for liabilities should be achieved.

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

Initial Recognition

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

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

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

Valuation Techniques

Authoritative accounting literature that provides guidance on how to determine fair value generally focuses on valuation techniques. However, the valuation technique selected should be consistent with the following:

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

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

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

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

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

Valuation Inputs and the Fair Value Hierarchy

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

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

a. Level 1—quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access.

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

c. Level 3—unobservable inputs.

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

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

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

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

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

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

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

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

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

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

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

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

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

a. Condition or location of the asset or liability.

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

c. Extent to which the inputs relate to items that are comparable to the asset or liability.

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

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

Investments in Entities That Calculate Net Asset Value Per Share. FASB ASC 820-10-35-59 provides a practical expedient to estimate fair value of an investment using net asset value per share or its equivalent if it has the following characteristics:

- it does not have a readily determinable fair value, *and*
- it is an investment in an investment company or is an investment in a real estate fund for which it is industry practice to measure investment assets at fair value on a recurring basis and to issue financial statements that are consistent with the measurement principles for investment companies.

The practical expedient permits not categorizing such investments within the fair value hierarchy. The authors believe small and midsize nonpublic entities are not likely to have such investments and, therefore, do not discuss the exemption further in this course.

Revised Fair Value Disclosures. In August 2018, the FASB issued ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement*. The FASB also recently issued Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 8, Notes to Financial Statements*. The amendments in ASU 2018-13 are the result of the Board's application of the newly issued Chapter 8 of Concepts Statement No. 8 to improve the effectiveness of disclosure requirements on fair value measurements.

Added Requirements. For public entities, the amendments in ASU 2018-13 require the following additional disclosures (these disclosures are optional for nonpublic entities):

- For recurring Level 3 fair value measurements at the end of the period, the amount of unrealized gains and losses for the period recognized in other comprehensive income.
- The range and weighted average of significant unobservable inputs used to develop fair value measurements for Level 3 assets and liabilities. Other quantitative information (e.g., median, arithmetic average) may be disclosed if used in lieu of weighted average.

Modified Requirements. The following disclosure requirements in FASB ASC 820 were modified by ASU 2018-13:

- For nonpublic entities: Rather than a reconciliation from opening to closing balances of recurring Level 3 fair value measurements, the following amounts are required to be disclosed during the period: purchases, issues, transfers into Level 3, and transfers out of Level 3, including the reasons for those transfers during the period.

- For all entities: For investments in entities that calculate net asset value, disclosures related to future liquidation are required only if the investee has communicated or publicly announced the timing. Otherwise, the entity should disclose that the timing is unknown.
- For public entities (optional for nonpublic entities): Additional information was provided to clarify that the requirement to disclose uncertainties in a Level 3 fair value measurement is for uncertainty due to the use of significant unobservable inputs (e.g., how the change in a significant unobservable input at year-end could affect the fair value measurement) and not for information about possible future fair value changes.

Removed Requirements. In addition, the amendments in ASU 2018-13 removed the following disclosure requirements:

- For nonpublic entities: For recurring Level 3 fair value measurements at the end of the period, the unrealized gains and losses included in earnings (or changes in net assets), including the line items in the statement of income (or activities) in which they are recognized.
- For all entities: The valuation process for Level 3 fair value measurements and the policy for when transfers between hierarchy levels occur. Note that entities are required to have and consistently follow a policy for when transfers between hierarchy levels occur (e.g., end of the period, date of the event that caused the transfer), but they are no longer required to disclose it.

ASU 2018-13 also includes an amendment to remove the phrase "at a minimum" from certain disclosure requirements to allow more judgment in applying disclosures to fair value measurements and clarify that materiality is always a consideration in determining the applicability of disclosure.

Effective Date. For all entities, the amendments in ASU 2018-13 are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted. An entity may also choose to early-adopt the removed or modified disclosure requirements and delay the adoption of the added disclosures until the effective date.

MATERIALITY CONSIDERATIONS

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

- Misstatements, including omissions, are considered to be *material* in circumstances when they, individually or in the aggregate, could reasonably be expected to influence the decisions of the users of the financial statements.
- The size or nature of a misstatement (or a combination of both) in light of surrounding circumstances affect judgments about *materiality*.
- The common financial information needs of users *as a group* are considered when making *materiality* judgments. What may be considered *material* to a *specific* individual user is not considered.

If the applicable financial reporting framework does not include a discussion of materiality, the accountant should consider the above characteristics as a frame of reference.

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

- In a financial statement preparation engagement—
  - AR-C 70.18 (AR-C 70A.18) indicates the accountant should disclose *material* departures from the applicable financial reporting framework.

- In a compilation engagement—
  - AR-C 80.13 (AR-C 80A.13) indicates the accountant should read the financial statements and consider whether they are appropriate in form and free from obvious *material* misstatements.
  - AR-C 80.29 (AR-C 80A.29) indicates the accountant should disclose *material* departures from the applicable financial reporting framework.
- In a review engagement—
  - AR-C 90.19 requires the accountant to determine materiality for the financial statements as a whole and to apply this materiality throughout the engagement.
  - AR-C 90.22 (AR-C 90A.15) indicates the accountant should obtain an understanding of the entity's business and accounting principles used to identify areas where there is a greater chance that *material* misstatements may exist.
  - AR-C 90.24 (AR-C 90A.17) indicates the accountant should design his or her review procedures to obtain sufficient appropriate review evidence (limited assurance, before implementing SSARS No. 25) as a basis for reporting whether the accountant is aware of any *material* modifications that should be made to the financial statements.
  - AR-C 90.26 (AR-C 90A.19) discusses applying analytical procedures to identify relationships and items that are unusual and may indicate a *material* misstatement.
  - AR-C 90.29f (AR-C 90A.22f) indicates the accountant should inquire of management concerning subsequent events that could have a *material* effect on the financial statements.
  - Both AR-C 90.67 and AR-C 90.69 (AR-C 90A.28 and AR-C 90A.30) address evaluating the *material-ity* of the evidence obtained.
  - AR-C 90.60l (AR-C 90A.34i) requires the accountant to get a written representation from management that they believe that the effects of uncorrected misstatements are *immaterial*.
  - The review report even addresses *materiality* when it states:

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

In compilations and reviews before implementing SSARS No. 25, the accountant's determination of materiality is a matter of professional judgment. However, SSARS No. 25 explicitly requires the accountant performing a review engagement to determine (and thus document) materiality for the financial statements as a whole and apply materiality in designing procedures and evaluating the results of the procedures performed. Further, the accountant is required to revise materiality if the accountant becomes aware of information that would have resulted in a different initial materiality amount. When making this judgment, the accountant may consider the needs of the users of the financial statements. According to AR-C 90.A39 (AR-C 90A.A7) it is reasonable for the accountant to assume that these users—

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

SELF-STUDY QUIZ

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

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

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

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

    c. The equity investors are obligated to absorb the entity's losses.

    d. The equity investors in the entity do not have the right to receive benefits from it.

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

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

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

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

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

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

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

    b. Unfamiliar with the transaction so as to be unbiased.

    c. Able to conduct the transaction at this time.

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

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

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

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

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

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

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

    a. Issues material to an individual statement user are an important factor when determining materiality.

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

    c. Misstatements must be material on their own to be considered in relation to materiality.

    d. If misstatements and omissions could influence a user's decision, they are considered material.

SELF-STUDY ANSWERS

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

12. Under what circumstances would an entity be considered to be a variable interest entity (VIE), assuming that the appropriate relationship between the entities exists? **(Page 70)**

    a. The entity has the equity to finance its own activities. [This answer is incorrect. One condition for being considered a VIE is that its equity is *not* sufficient to finance its activities without additional subordinated financial support.]

    b. The entity's equity investors have the power to direct all of its activities. [This answer is incorrect. One condition that indicates an entity is a VIE is when the equity investors do *not* have the power to direct the activities of the entity that most significantly impact its economic performance.]

    c. The equity investors are obligated to absorb the entity's losses. [This answer is incorrect. An entity could be a VIE if its equity investors are *not* obligated to absorb its losses.]

    d. **The equity investors in the entity do not have the right to receive benefits from it. [This answer is correct. Once the reporting entity determines that it has a relationship that requires it to consider the authoritative literature on accounting for a VIE, the next step is to consider whether the entity with which the reporting entity has the relationship is a VIE. Generally, an entity is considered to be a VIE if either of two conditions are met. One of those conditions is that the equity investors in the entity do not have the right to receive its benefits.]**

13. Which of the following entities has presented *consolidated* financial statements? **(Page 75)**

    a. The Red Company presents a balance sheet, and statements of income, comprehensive income, retained earnings, and cash flows. [This answer is incorrect. This is an example of a set of basic financial statements. There is not enough information included in this scenario to determine if the Red Company's financial statements are consolidated or not. Therefore, another answer to this question would be more appropriate.]

    b. **The Blue Company's statements aggregate its financial position with that of its subsidiary. [This answer is correct. *Consolidated financial statements* combine a parent company's financial position and results of operations with those of its subsidiaries as if they were a single entity.]**

    c. The Green Company's statements present its financial position and its subsidiary's in columnar form. [This answer is incorrect. *Consolidating financial statements* usually present the financial position and results of operations of the parent company and each of its subsidiaries in columnar form, together with columns that show eliminations of intercompany items and the consolidated totals.]

    d. The Yellow Company and the Purple Company have common management and present their financial statements as one. [This answer is incorrect. FASB ASC 810-10-55-1B states, "There are circumstances, however, where combined financial statements (as distinguished from consolidated financial statements) of commonly controlled companies are likely to be more meaningful that their separate financial statements." The guidance goes on to indicate that it might be more meaningful to use combined financial statements for (1) two or more companies that are related in their operations and are controlled by the same individual, (2) a group of unconsolidated subsidiaries, or (3) companies under common management (like the Yellow and Purple Companies in this scenario).]

14. Which of the following would be a characteristic of an appropriate market participant when determining an asset's fair value? **(Page 79)**

    a. A related party of the entity or a member of management. [This answer is incorrect. For a proper fair value determination, the hypothetical market participants need to be independent of the reporting entity (i.e., not related parties).]

b. Unfamiliar with the transaction so as to be unbiased. [This answer is incorrect. Appropriate market participants should be reasonably knowledgeable of the asset or liability and the transaction based on available information. Therefore, they should not be unfamiliar with the transaction.]

c. **Able to conduct the transaction at this time. [This answer is correct. Fair value should be measured based on the assumptions market participants would use in pricing the asset or liability. One of the characteristics of a market participant for this determination is one who is able to conduct the transaction (e.g., has available funds in place).]**

d. Participating in the exchange because of a contractual obligation. [This answer is incorrect. When determining fair value, the market participant should be willing to conduct the transaction of its own accord. Therefore, a seller who is obligated to accept the price would not qualify.]

15. Which of the following is considered a Level 1 input in the fair value hierarchy? **(Page 81)**

a. **A quoted price for an identical asset in an active market. [This answer is correct. A quoted price in an active market for an identical asset or liability is a Level 1 input. Level 1 inputs are considered to be the most reliable evidence of fair value. Active markets are those in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis.]**

b. A quoted price in an active market for a similar asset. [This answer is incorrect. This is considered a Level 2 input which is not as desirable as a Level 1 input.]

c. Information developed by the entity using its own data. [This answer is incorrect. This is an example of a Level 3 input and is the lowest level of the fair value hierarchy.]

d. A quoted price for an identical asset in an inactive market. [This answer is incorrect. This type of input would be considered a Level 2 input.]

16. Which of the following statements best describes how different financial reporting frameworks discuss materiality? **(Page 83)**

a. Issues material to an individual statement user are an important factor when determining materiality. [This answer is incorrect. The common financial information needs of users as a *group* are considered when making materiality judgments. What may be considered material to a specific individual user is not considered.]

b. The size of a particular misstatement is the most important factor when determining materiality. [This answer is incorrect. The size and nature of a misstatement (or a combination of both) in light of surrounding circumstances affect judgments about materiality, not just the size.]

c. Misstatements must be material on their own to be considered in relation to materiality. [This answer is incorrect. Misstatements are considered in relation to materiality both individually and in the aggregate.]

d. **If misstatements and omissions could influence a user's decision, they are considered material. [This answer is correct. Misstatements, including omissions, are considered to be *material* in circumstances when they, individually or in the aggregate, could reasonably be expected to influence the decisions of the users of the financial statements.]**

Lesson 2: Partnerships

INTRODUCTION

This lesson takes a look at various issues associated with partnerships, including limited liability companies and limited liability partnerships.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine proper reporting for various partnership issues such as accounting basis, partner loans, partner capital, investments, and changes in legal form.
- Identify accounting and reporting issues of LLCs and LLPs.

Selecting an Accounting Basis

Generally, the partnership agreement dictates the accounting basis to be used in preparing a partnership's financial statements. Frequently, the agreement will specify the cash or tax basis of accounting, both of which are considered a special purpose framework for financial reporting. Because of the complicated Internal Revenue Service provisions applicable to partnerships, many accountants encourage their partnership clients to use the tax basis of accounting. Likewise, many limited partnerships are designed to provide maximum tax benefits to the partners, and great emphasis is placed on the tax basis of the assets. Thus, most frequently, partnerships present their financial statements on the tax basis of accounting.

Cash and tax basis statements do not purport to present financial position and results of operations in accordance with GAAP. Thus, partnership financial statements presented on the cash or tax basis are not described in terms that are generally applicable to GAAP basis statements unless the financial statement titles are appropriately modified [AR-C 80.A28 (AR-C 80A.A28) and AR-C 90.A126 (AR-C 90A.A82)]. For example, instead of "Balance Sheet," the title "Balance Sheet—Tax Basis" may be used. Similarly, instead of "Income Statement," the title "Statement of Revenues and Expenses—Tax Basis" may be used. Also, a statement of cash flows is not required for tax or cash basis partnership financial statements because the statements do not purport to present financial position and results of operations in accordance with GAAP.

If the partnership agreement does not specify a basis of accounting other than GAAP, the partnership financial statements includes all statements required by GAAP, which would include:

a. Balance Sheet.
b. Statement of Income.
c. Statement of Changes in Partners' Capital.
d. Statement of Cash Flows.

The basic financial statement presentation principles discussed in Lesson 1 are applied to partnership financial statements presented on the accrual basis. The following section discusses financial statements that are not in accordance with either GAAP nor the cash or tax basis. That may happen for example, when a partnership agreement stipulates the basis of accounting, which results in financial statements prepared in accordance with a *contractual basis of accounting*.

FINANCIAL STATEMENTS PREPARED USING THE CONTRACTUAL BASIS OF ACCOUNTING

AR-C 60.07 (AR-C 80A.05 and AR-C 90A.05) states that the *contractual basis of accounting* is a *special purpose framework*. A special purpose framework includes the cash basis, tax basis, regulatory basis, and other basis as well as the contractual basis of accounting. Thus, the reporting guidance in AR-C 80 (AR-C 80A) and AR-C 90 (AR-C 90A) for contractual basis financial statements is substantially the same as it is for cash and tax basis statements. For example, reports on all special purpose financial statements are required to refer to management's responsibility to determine the applicable financial reporting framework if there is a choice of financial reporting frameworks and include a separate paragraph that (a) indicates that the financial statements were prepared in accordance with the applicable special purpose framework (in this instance, contractual); (b) refers to the note that describes the framework (if applicable); and (c) states that the framework is a basis of accounting other than GAAP. However, for special purpose financial statements prepared in accordance with a contractual basis of accounting, the separate paragraph should also state that the financial statements may not be suitable for another purpose.

In addition, when reporting on contractual basis financial statements, the accountant is required to—

a. Describe in the report, or refer to a note that describes, the purpose for which the financial statements have been prepared. The purpose of this is to avoid misunderstandings when the financial statements are used for purposes other than those for which they were intended. This note also may describe any significant interpretations of the contract as discussed in item b [AR-C 80.20 (AR-C 80A.20) and AR-C 90.79 (AR-C 90A.42)].

b. Modify the report if significant interpretations of the contract are not adequately described in the financial statements [AR-C 80.19 (AR-C 80A.19) and AR-C 90.78 (AR-C 90A.41)].

If the accountant has reviewed the contractual basis financial statements, AR-C 90.81 (AR-C 90A.44) requires the accountant to also add to the report an other-matter paragraph that restricts the use of the report. Although not required for compiled contractual basis financial statements, the authors recommend adding the restricted use paragraph to the compilation report.

If there are departures from the reporting requirements of the partnership agreement (that is, the contractual basis), the accountant should modify the report for a departure from the special purpose framework AR-C 80.29–.33 (AR-C 80A.29–.33) and AR-C 90.71–.72 (AR-C 90A.56–.60).

Client Interpretations of the Partnership Agreement

When the accountant is engaged to compile or review financial statements prepared in accordance with a contractual basis of accounting, AR-C 80.19 (AR-C 80A.19) and .AR-C 90.78 (AR-C 90A.41) require that the accountant's report include a description of any significant interpretations made by the client regarding provisions of the agreement. The interpretation descriptions that would be included will vary depending upon the terms of the agreement. The accountant is also required to modify the report if the financial statements do not adequately describe the significant interpretations. SSARS No. 25 explicitly states that the accountant should consider whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based to determine whether a report modification is needed. Prior to implementation of SSARS No. 25, the consideration of the adequacy of the description of the significant interpretations is implicit.

ISSUES RELATED TO FEDERAL INCOME TAXES

Income from a partnership is taxed to the partners rather than to the partnership. Therefore, the financial statements of the partnership would not include federal income tax expense or the related liability. If the statement of income shows net income after federal income taxes, it is not prepared in accordance with GAAP (nonauthoritative AICPA Technical Q&A 7200.02). However, when the partnership's financial statements are presented on an accrual basis, it may be appropriate to record a liability for any substantial partner withdrawals that are anticipated in order to pay income taxes and that are formally approved before the balance sheet date. Although not required by GAAP, the authors recommend that the financial statements disclose (a) that the partnership does not pay income taxes and (b)

any anticipated withdrawals by partners to pay income taxes, whether or not recorded as a liability in the financial statements. With respect to item (b), the accountant would consider disclosing any withdrawals made since the balance sheet date. An illustrative note follows:

> NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
>
> Federal Income Taxes
>
> The partnership is not a taxpaying entity for federal income tax purposes, and thus no income tax expense has been recorded in the statements. Income from the partnership is taxed to the partners in their individual returns. The partners customarily make substantial capital withdrawals in April of each year to pay their personal income tax liabilities. At December 31, 20X1, $75,000 has been deposited in a partnership savings account in anticipation of partner withdrawals.

FASB ASC 740-10-50-16 requires public entities that are not subject to income taxes because income is taxed directly to their owners to disclose that fact and the net difference between the financial and tax bases of the entities' assets and liabilities. The requirement generally applies to mutual funds, real estate investment trusts, regulated investment companies, and certain partnerships. Although FASB ASC 740-10 does not require nonissuers to disclose similar information, the authors recommend disclosing that income is taxed directly to the owners and that as a result, the partnership did not recognize a provision for income taxes, as illustrated in the preceding paragraph. Also, in some circumstances, nonissuers may consider it useful to disclose their temporary differences. The authors believe that the disclosure of the nature of temporary differences ordinarily will satisfy the primary users of the financial statements and, thus, do not believe it will be necessary to disclose the amount of the basis differences.

Occasionally, a partnership agreement requires that a provision for income taxes be computed at a specified rate and be included as an expense of the partnership. The inclusion of such a tax provision is a departure from GAAP and should be reported as such.

Accounting for Uncertainty in Income Tax and Partnerships

The measurement and disclosure principles of FASB ASC 740-10 generally do not affect the financial statements of an entity that is not potentially subject to income taxes. To illustrate, assume that the IRS examines the Form 1065 of a partnership and disallows certain deductions. Any additional income taxes will be imposed on the partners rather than the partnership, and accordingly, FASB ASC 740-10 would have no effect on the partnership's financial statements.

However, while it is unlikely that a partnership will pay a tax, it can be subject to failure-to-file penalties. Some businesses cross borders and do not register in another state and then later have to pay penalties for failure to timely file a return. Even the federal government now charges penalties of so much per partner per month for late filing. In addition, there is a disclosure requirement even if there are no uncertain tax positions. FASB ASC 740-10 as it relates to pass-through entities is discussed in more detail in Lesson 3.

STATE INCOME TAX AND FRANCHISE TAX

If a state or other taxing authority levies a tax on the partnership and the tax is based on net income, the financial statements would show the tax as an expense of the partnership. Because the payment of income taxes by a partnership is rare, the financial statements would disclose the nature of the tax (if material).

MAKING GUARANTEED PAYMENTS TO PARTNERS

Guaranteed payments to partners are often made as salary payments for services or interest on capital accounts. The conventional method of accounting for such payments is to treat them as part of the allocation of partnership net income, rather than as an expense in determining net income. However, in some situations, e.g., when the payments are designed to reflect reasonable compensation for services, it may be more meaningful to show the payments as expenses of the partnership. Whenever guaranteed payments are material, the method of accounting for them would be included in the accounting policies disclosures.

CLASSIFYING LOANS BETWEEN PARTNERS AND THE PARTNERSHIP

Loans from partners to the partnership, which are greater than the capital required to be contributed, are conventionally accounted for as loans rather than capital. In most states, such loans have preferential treatment over capital upon dissolution. Thus, they would be classified in the balance sheet as liabilities rather than capital, and interest on the loans would be recorded as an expense of the partnership. The appropriate disclosures required for related party transactions and notes payable are illustrated in the following example:

> NOTE C—NOTES PAYABLE TO PARTNERS
>
> The notes payable to partners represent unsecured demand loans payable to certain partners. Interest on the notes is payable quarterly at the prime interest rate charged by local banks.

Loans to partners, which are not intended to be withdrawals of capital or profits, are considered assets of the partnership by law in most states. These loans would be recorded in the balance sheet as an asset rather than a reduction of capital. Again, a related party disclosure, such as the following, is appropriate:

> NOTE D—LOANS TO PARTNERS
>
> Loans to partners are 180-day unsecured loans due May 31, 20X1. The loans bear interest at the rate of 10% per annum, payable at maturity.

THE EQUITY SECTION OF THE BALANCE SHEET

The equity section of the balance sheet of a partnership is labeled "Partners' Capital." In some situations, it may be desirable to disclose the capital accounts of the individual partners or classes of partners. Examples of such presentations on the face of the balance sheet follow:

PARTNERS' CAPITAL	
John Jones	$ 50,000
Jim Smith	130,000
Bill Adams	85,000
	$ 265,000
PARTNERS' CAPITAL (DEFICIT)	
General Partner	$ 110,000
Limited partners	(1,275,000)
	$ (1,165,000)

The same type of presentation might also be made in a note, rather than on the face of the statements.

Generally, no distinction is made on the balance sheet between capital contributed, beginning capital, or retained earnings, as is done for corporations. However, as discussed in the following section, a statement of changes in partners' capital may be necessary.

THE STATEMENT OF CHANGES IN PARTNERS' CAPITAL

As discussed in Lesson 1, FASB ASC 505-10-50-2 requires changes in the stockholders' equity accounts to be *disclosed* whenever the financial statements purport to present both financial position and results of operations. While not specifically discussed in accounting literature, the authors also believe financial statements on the cash or tax basis of accounting or financial statements of entities other than corporations would disclose changes in the components of the capital or equity section of the balance sheet. Accordingly, changes in partners' capital would be

disclosed. In many cases, these changes can be best disclosed by presenting a combined statement of income and changes in partners' capital as follows:

NET INCOME	$ 150,000
BEGINNING PARTNERS' CAPITAL	225,000
Drawings for the year	(145,000)
Additional capital contributed	30,000
ENDING PARTNERS' CAPITAL	$ 260,000

It may be preferable to present a separate statement of changes in partners' capital in circumstances such as the following:

a. When more detail or description of the transactions is desired.

b. When comparative statements are presented.

c. When changes in individual partners' capital accounts are presented.

Exhibit 2-1 and Exhibit 2-2 show examples of separate "Statements of Changes in Partners' Capital."

Exhibit 2-1

Example Statements of Changes in Partners' Capital

ABC DISTRIBUTING PARTNERSHIP
STATEMENTS OF CHANGES IN PARTNERS' CAPITAL
Years Ended December 31, 20X2 and 20X1

	20X2	20X1
BEGINNING PARTNERS' CAPITAL	$ 110,000	$ 75,000
Net income for the year	90,000	60,000
Capital contributed	—	15,000
Capital withdrawn	(55,000)	(40,000)
ENDING PARTNERS' CAPITAL	$ 145,000	$ 110,000

See accompanying notes and accountant's report.

Exhibit 2-2

Example Statement of Changes in Partners' Capital

XYZ PARTNERSHIP
STATEMENT OF CHANGES IN PARTNERS' CAPITAL
Year Ended December 31, 20X2

	Partner X	Partner Y	Partner Z	Total
BEGINNING CAPITAL	$ 50,000	$ 75,000	$ 40,000	$ 165,000
Share of net income	85,000	60,000	45,000	190,000
Capital contributed	—	—	10,000	10,000
Drawings	(80,000)	(70,000)	(40,000)	(190,000)
ENDING CAPITAL	$ 55,000	$ 65,000	$ 55,000	$ 175,000

See accompanying notes and accountant's report.

ACCOUNTING FOR CHANGES IN PARTNERSHIP INTEREST

FASB ASC 805, *Business Combinations*, provides acquired entities the option of applying pushdown accounting in their separate financial statements as of the date a controlling interest is obtained. The option can be elected each time an event occurs in which an acquirer obtains control of an acquiree. FASB ASC 805-50-25-7 indicates that electing pushdown accounting in a reporting period after a change in control occurs is a change in accounting principle. In addition, FASB ASC 805-50-25-9 states that, if the option is elected, it is irrevocable. Because the option is only available when there has been a change in control, it is not available for a combination of commonly-controlled entities.

According to FASB ASC 805-50-30-10, pushdown accounting generally pushes down the values recorded by the acquiring entity in a business combination accounted for under FASB ASC 805. However, although goodwill may be recognized, FASB ASC 805-50-30-11 prohibits including bargain purchase gains in earnings. Instead, they are to be recognized as an adjustment of equity. In addition, under FASB ASC 805-50-30-12, any acquisition-related liability incurred by the acquirer is pushed down only if the liability represents an obligation of the acquiree.

PPC's Guide to Preparing Financial Statements discusses push-down accounting in detail, including a variety of illustrations. The guidance applies to all forms of entities. Accordingly, the authors believe there is no need to separately discuss applying the method to partnerships.

INVESTMENTS IN PARTNERSHIPS AND JOINT VENTURES

The accounting requirements for investments in corporations apply to investments in partnerships. FASB ASC 810-10-15-3 requires consolidation when the reporting entity controls the partnership, and FASB ASC 323-30-25-1 requires using the equity method when the reporting entity does not control the partnership but has the ability to exercise significant influence over it.

If the equity method is used to account for an investment in a partnership, e.g., when the investor has more than a 20% interest and has the ability to exercise significant influence over partnership policies, the investor would record its prorata share of partnership profits or losses by adjusting the carrying amount of its investment in the partnership.

The equity method ordinarily is discontinued when the investment (and net advances) are reduced to zero. However, if the investor has guaranteed obligations of the partnership or is otherwise committed to provide further financial support, losses would continue to be recorded by the investor to the extent of the additional funds committed. An

investment in a partnership accounted for by the equity method that has been reduced below zero would be presented as a liability in the balance sheet.

GAAP also states that the equity method is not a valid substitute for consolidation. Accountants should consider whether FASB ASC 810, *Consolidation*, requires consolidation because the reporting entity controls the partnership through a means other than ownership of a majority voting interest. FASB ASC 810 provides guidance on criteria for determining when looking at nominal voting rights is not effective for determining if the reporting entity has a controlling financial interest in the partnership and provides guidance on looking for a controlling financial interest in those situations.

A limited partnership has at least one general partner and one limited partner, but it may have more than one general partner and/or more than one limited partner. Often, the general partner interest is smaller than the limited partner interest

GAAP requires a limited partnership to be evaluated for consolidation as a variable interest entity unless the limited partners possess, at a minimum, either of the following:

a. the substantive ability to dissolve the limited partnership or remove the general partner interest without cause, which is referred to as *substantive kick-out rights*, or

b. substantive participating rights.

If those characteristics are present, the limited partnership is evaluated for consolidation as a voting interest entity. (However, even entities that possess those characteristics might be considered VIEs if they meet any of the other criteria in FASB ASC 810-10-15-14.)

FASB ASC 810-10-15-14 and 810-10-25-14A specify two conditions that must exist for kick-out rights to be substantive:

a. they generally must be capable of being exercised by a single limited partner or a vote of no more than a simple majority of the limited partner interest, and

b. there must be no significant barriers to the exercise of the rights.

Substantive participating rights provide the limited partner interest with the ability to block or participate in significant financial and operating decisions that would be expected to be made in the ordinary course of the limited partnership's business. FASB ASC 810-10-25-11 gives two examples of substantive participating rights:

a. Hiring, terminating, and determining the compensation of management responsible for the implementation of policies and procedures.

b. Making operating and capital decisions, such as establishing budgets.

If a limited partnership qualifies for evaluation as a voting interest entity because the limited partners possess the preceding rights, FASB ASC 810-10-25-1A establishes the presumption that the owner of a majority of the limited partnership's kick-out rights through voting interests has a controlling financial interest in the limited partnership.

FASB ASC 810-10-25-5 states that judgment is required to assess whether the presumption of control can be overcome, but the limited partner with the majority of kick-out rights through voting interests does *not* have a controlling financial interest if other limited partners have substantive participating rights. That is, if a noncontrolling limited partner can veto the controlling limited partner's decisions that would cause the general partner to take actions that are significant in the ordinary course of business, then the presumption of control is overcome. The evaluation of noncontrolling rights is made when a majority of kick-out rights through voting interests is obtained, and should be re-evaluated if there is a significant change in the terms or the ability of a noncontrolling limited partner to exercise its approval or veto rights.

Thus, under the voting interests model, a general partner will not consolidate a limited partnership because, by definition, the limited partners possess either substantive kick-out rights or substantive participating rights. However, under the variable interests model, if the general partner meets both the "power" and "losses and benefits" tests,

then, according to FASB ASC 810-10-25-38C, a kick-out or participating right exercisable unilaterally by a single entity (including its related parties and de facto agents) would be needed for the general partner to avoid consolidation. Because the authors believe it is uncommon for small and midsize nonpublic entities to grant limited partners substantive kick-out or participating rights, in most cases the authors believe limited partnerships will be considered VIEs and the general partner will be considered the primary beneficiary.

A summary of the accounting considerations when the reporting entity is a partner in a limited partnership follows:

Step 1 Does the limited partnership qualify for consideration as a voting interest entity?

(i) Yes. Go to step 2.

(ii) No. Follow the consolidation guidance in the VIE Subsections of FASB ASC 810 to determine if consolidation is required.

Step 2 Does the reporting entity own a majority of the limited partnership's kick-out rights through voting interests?

(i) Yes. Go to step 3.

(ii) No. Consolidation is not required. The reporting entity should ordinarily account for its interest in the limited partnership using the equity method.

Step 3 Do noncontrolling partners hold substantive participating rights?

(i) Yes. Consolidation is not required. The reporting entity should ordinarily account for its interest in the limited partnership using the equity method.

(ii) No. The reporting entity must include the consolidated financial results of the limited partnership in its financial statements.

PARTNERSHIP RETIREMENT PLANS

A partnership may set up a retirement plan patterned after profit sharing, pension, or other types of employee benefit plans used by corporations. There is no authoritative guidance on how to account for such plans in a partnership. Thus, there is diversity in practice as to whether payments to partners and related retirement benefits are an expense to the partnership or a distribution of partner equity.

Retirement plans are required by federal income tax laws to include present and future employees other than the partners. Therefore, in the authors' opinion, payments to such plans would be recorded as expenses of the partnership rather than as withdrawals of capital. When the partnership makes payments to employees' IRAs as well as to those of the partners (SEP-IRAs), the payments would be recorded as an expense of the partnership.

Regardless of the method used to account for partner payments, the significant provisions of the partnership's plan and the accounting policy for the partners' portion would be properly disclosed in the notes to the financial statements.

MAKING A CHANGE IN LEGAL FORM OF ENTITY

A change in the legal form of business (for example, from or to a partnership) is not considered a change in accounting principle (or change in reporting entity) and is, therefore, not subject to the accounting and disclosure requirements of FASB ASC 250-10. Absent any authoritative accounting and disclosure guidance that addresses such a change, the authors recommend that disclosure of the change in legal form and/or tax status be made in the notes to the financial statements.

When one or more prior years' statements are presented after a change to or from a partnership, the question often arises as to whether prior year statements should be modified. FASB ASC 250-10 implies that a change to or from partnership status is not viewed as a change in accounting principle. Therefore, retrospective application is

inappropriate. However, in order to enhance the comparability, it may be necessary to modify the format of the prior year statements. If that is done, a note may be included to disclose the change.

As a practical matter, especially when a corporation is converted to a partnership, accountants may choose to recommend that their partnership clients present single-period statements for the first reporting period following the change.

SELF-STUDY QUIZ

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

17. Which of the following should be done when an accountant reports on partnership financial statements prepared using the contractual basis of accounting?

    a. Confirm that a balance sheet, statement of income, statement of changes in partners' capital, and statement of cash flows are included.

    b. Describe in the accountant's report or include reference to a note that describes the purpose for which the statements were prepared.

    c. Modify the financial statements if significant contract interpretations are not properly described in them.

    d. Make a special notification to the IRS due to the complex tax issues that apply to partnership statements prepared on the contractual basis.

18. When would an entity stop using the equity method to account for an investment in a partnership?

    a. When the investor's interest is more than 20%.

    b. When the investment is reduced below zero.

    c. When the financial statements would otherwise be consolidated.

    d. When use of the pushdown method of accounting is elected.

SELF-STUDY ANSWERS

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

17. Which of the following should be done when an accountant reports on partnership financial statements prepared using the contractual basis of accounting? **(Page 90)**

    a. Confirm that a balance sheet, statement of income, statement of changes in partners' capital, and statement of cash flows are included. [This answer is incorrect. If the partnership agreement does not specify a basis of accounting other than GAAP, the partnership financial statements should include all statements required by GAAP. However, when the contractual basis of accounting (a special purpose framework) is used, GAAP requirements might not apply in the same way.]

    b. **Describe in the accountant's report or include reference to a note that describes the purpose for which the statements were prepared. [This answer is correct. When reporting on contractual basis financial statements, the accountant is required to, among other things, describe in the report, or refer to a note that describes, the purpose for which the financial statements have been prepared. The purpose of this is to avoid misunderstandings when the financial statements are used for purposes other than those for which they were intended.]**

    c. Modify the financial statements if significant contract interpretations are not properly described in them. [This answer is incorrect. When reporting on contractual basis financial statements, the accountant is required to, among other things, modify the *report* if significant interpretations of the contract are not adequately described in the financial statements. It would not be appropriate for the accountant to modify the financial statements.]

    d. Make a special notification to the IRS due to the complex tax issues that apply to partnership statements prepared on the contractual basis. [This answer is incorrect. Because of the complicated IRS provisions applicable to partnerships, many accountants encourage their partnership clients to use the tax basis of accounting. However, no special IRS notification is required if the partnership uses a different special purpose framework, including the contractual basis.]

18. When would an entity stop using the equity method to account for an investment in a partnership? **(Page 94)**

    a. When the investor's interest is more than 20%. [This answer is incorrect. FASB ASC 323-30-25-1 requires using the equity method when the reporting entity does not control the partnership but has the ability to exercise significant influence over it, typically when the investor has more than 20% interest and the ability to exercise significant influence over partnership policies.]

    b. **When the investment is reduced below zero. [This answer is correct. The equity method ordinarily is discontinued when the investment and net advances are reduced to zero. However, if the investor has guaranteed obligations of the partnership or is otherwise committed to provide further financial support, losses would continue to be recorded by the investor to the extent of the additional funds committed. An investment in a partnership accounted for by the equity method that has been reduced below zero would be presented as a liability in the balance sheet.]**

    c. When the financial statements would otherwise be consolidated. [This answer is incorrect. GAAP states that use of the equity method is not a valid substitute for consolidation.]

    d. When use of the pushdown method of accounting is elected. [This answer is incorrect. As described in FASB ASC 805, *Business Combinations*, acquired entities have the option of applying pushdown accounting in their separate financial statements as of the date a controlling interest is obtained. However, this election relates to acquired entities, not to investments in a partnership.]

CONSIDERATIONS FOR LIMITED LIABILITY COMPANIES

Limited liability companies (LLCs) are business entities created under state law that can be used in all states. LLCs are owned by members and combine many of the tax advantages of a partnership with the liability protection of a corporation. In many cases, LLCs are more flexible than S corporations. Each state establishes its own LLC rules and characteristics.

Advantages and Disadvantages of LLCs

Advantages. Advantages of LLCs include the following:

- They have limited liability (that is, members generally are not personally liable for the LLC's debts or liabilities, except to the extent of their investment and any remaining capital commitment to the LLC).
- The number of members is not limited.
- Members may be individuals, corporations, trusts, partnerships, LLCs, or others.
- Double taxation affecting most C corporations is avoided. Income is passed through to the members for Federal income tax purposes.
- Members can participate in managing the LLC without forgoing limited liability.
- Distributions to members do not have to be directly proportional to the members' ownership percentages as they do for S corporations.
- They can have different classes of ownership.
- A member's creditor has limited power to satisfy his or her claim with the LLC's assets because the creditor may only receive a charging order allowing receipt of the distributions that would have been made to the debtor-member.

Disadvantages. Disadvantages of LLCs include the following:

- They sometimes have a limited life, such as by termination on the death or bankruptcy of a member.
- Transfer of interests is more difficult. (Under most LLC statutes, a member can assign his or her interest to a nonmember, but the assignee cannot become a substitute member and acquire all of the attributes of the assigning member's interest unless the remaining members consent to the transfer. Without such approval, the assignee is entitled only to receive the distributions to which the assigning member otherwise would be entitled. Accordingly, interests in LLCs formed under those statutes are not freely transferable.)
- The enacted laws vary from state to state. Therefore, the LLC must determine how it will be treated for both tax and liability purposes in the state of formation, as well as in any other states in which they do business.
- Members who have management authority, debt responsibility, or who materially participate are exposed to self-employment tax.

Assisting Clients. Clients considering establishing a new business as an LLC or converting an existing entity into an LLC need to carefully consider the advantages and disadvantages as previously discussed. Accountants may assist clients by researching the LLC statutes of the states in which the client plans to do (or does) business. Knowledge of those factors, along with an understanding of the basic characteristics of an LLC, would allow accountants to assist their clients in making the best decision. (Note that when researching LLC statutes, accountants often consult with the client's attorney.)

Organization

Although there is a Uniform Limited Liability Company Act, not all states have adopted it as the model for state LLC statutes. Accordingly, differences exist among the various state statutes. By necessity, this discussion of LLCs is general in nature and should not be considered a substitute for obtaining a thorough understanding of applicable state LLC statutes.

Articles of Organization. An LLC is established by filing articles of organization with the appropriate state agency. Generally, an LLC can conduct any lawful business except for those expressly prohibited by the applicable LLC statute or which are prohibited under other state statutes regulating particular business activities (e.g., usually banking and insurance). Most state LLC laws require that the company's name include a designation of its legal status such as "Limited Liability Company," or "LLC."

Operating Agreement. The owners of an LLC are referred to as members, and their rights and powers are usually provided in the company's "operating agreement." The operating agreement is the LLC equivalent of a partnership agreement or corporate bylaws.

General Tax Treatment

The attractiveness of LLCs depends on their classification as partnerships for federal income tax purposes. Domestic LLCs with more than one member are by default classified as partnerships for federal income tax purposes. (LLCs also can elect to be treated as corporations; however, that option is attractive only in limited circumstances, such as when S corporation status is desired to minimize the owners' liability for payroll taxes on their earnings.)

Single-member LLCs. A domestic single member LLC is a disregarded entity by default. That means its existence will be ignored for federal income tax purposes, and the income and expenses of the LLC will be taxed to the LLC's owner. (Alternatively, a single-member LLC can elect to be taxed as a corporation.) For example, an LLC business owned by a single individual is treated as a sole proprietorship. An LLC business wholly owned by another legal entity, such as a corporation, is treated as an unincorporated branch of the parent entity. A corporation owning a single-member LLC is not required to file a consolidated return, but merely reports the LLC's income and expenses as if they were the corporation's.

Classification Election. LLCs wishing to elect a classification different from their default classification (i.e. who wish to be classified as corporations) must make an election on Form 8832 (Entity Classification Election). The same is true when an LLC later wishes to change its existing classification. An entity that elects to change its classification cannot change its classification again during the 60 months after the effective date of the election [Reg. 301.7701-3(c)(1)(iv)]. This rule does not apply to a newly formed entity's election out of its default classification at inception or if more than 50% of the entity's ownership interests as of the date of the subsequent election are owned by persons that did not own any interest in the entity when the entity's prior election was made.

Conversion of an Existing Entity to an LLC. Internal Revenue Service rulings generally have held that the conversion of a partnership to an LLC (whether by merger or otherwise) is treated as a continuation of the partnership with no tax consequences, unless the conversion causes a shift in the allocation of liabilities among the partners/members. If a shift in liabilities causes a deemed distribution of cash in excess of a member's basis in the LLC, a gain will be recognized. A shift in liabilities may also result in the recognition of gain if a member's amount at risk is reduced below zero because of the liability shift. The conversion of a corporation to an LLC (assuming the LLC is treated as a partnership) will result in the recognized liquidation of the corporation and the formation of a new partnership for federal income tax purposes, with all of the accompanying tax consequences. Gain or loss will potentially be recognized by the shareholders, as well as by the corporation on the disposition of its property upon liquidation.

Accounting and Reporting Issues

While LLCs are unique legal entities, they do not give rise to a significant number of accounting or reporting issues that differ from those of partnerships. FASB ASC 272-10 provides guidance on applying existing accounting literature to LLCs. [That guidance also applies to limited liability partnerships (LLPs) discussed in the next section.]

The remainder of this section discusses some of the unique issues accountants typically address when compiling or reviewing the financial statements of LLCs.

Financial Statement Headings. The headings of an LLC's financial statements should clearly identify the entity as an LLC. FASB ASC 272-10-45-2 requires this even in jurisdictions where LLCs are not required by law to include the LLC designation in their names.

Federal Income Taxes. If the LLC is classified as a partnership for federal income tax purposes, income is taxed to the members rather than to the LLC. As noted earlier in this lesson regarding partnerships, the financial statements of the LLC would not include federal income tax expense or the related liability. If the statement of income shows net income after federal income taxes, it is not prepared in accordance with GAAP. However, if the LLC's financial statements are presented on an accrual basis, it may be appropriate to record a liability for any substantial member withdrawals that are anticipated in order to pay income taxes and that are formally approved before the balance sheet date. Although not required by GAAP, the authors recommend that the financial statements disclose (a) that the LLC does not pay federal income taxes and (b) any anticipated withdrawals by members to pay income taxes, whether or not recorded as a liability in the financial statements. With respect to item (b), the accountant needs to consider disclosing any withdrawals made since the balance sheet date. An illustrative note follows:

> NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
>
> Federal Income Taxes
>
> The Company is not a taxpaying entity for federal income tax purposes, and thus no income tax expense has been recorded in the statements. Income of the Company is taxed to the members in their respective returns. The members customarily make substantial capital withdrawals in April of each year to pay their federal income tax liabilities. At December 31, 20X1, $75,000 has been deposited in a Company savings account in anticipation of member withdrawals.

FASB ASC 740-10 requires issuers that are not subject to income taxes because income is taxed directly to their owners to disclose that fact and the net difference between the financial and tax bases of the entities' assets and liabilities. The requirement generally applies to mutual funds, real estate investment trusts, regulated investment companies, and certain partnerships. Although FASB ASC 740-10 does not require nonissuers to disclose similar information, the authors recommend disclosing that income is taxed directly to the owners and that as a result, the company did not recognize a provision for income taxes, as illustrated in the preceding paragraph. Also, in some circumstances, nonissuers may consider it useful to disclose their temporary differences. The authors believe that the disclosure of the nature of temporary differences ordinarily will satisfy the primary users of the financial statements and, thus, do not believe it will be necessary to disclose the amount of the basis differences.

An LLC's operating agreement may also require that a provision for income taxes be computed at a specified rate and be included as an expense of the LLC. The inclusion of such a tax provision is a departure from GAAP and would be reported as such.

State Income and Franchise Taxes. Depending on the state of organization, an LLC may be subject to significant state income or franchise taxes. If a state or other taxing authority levies a tax on the LLC and the tax is based on net income, as discussed earlier regarding partnerships, the financial statements would show the tax as an expense of the LLC. Furthermore, if taxable income differs significantly from book income, deferred taxes should be recorded in accordance with FASB ASC 740-10. The financial statements also should disclose the nature of the tax (if material). If the LLC's tax status in a jurisdiction changes from taxable to nontaxable, any deferred tax assets and liabilities related to that jurisdiction should be eliminated.

Equity Section of the Balance Sheet. Since owners of an LLC are referred to as members, FASB ASC 272-10-45-3 states that the equity section of the balance sheet should be labeled "Members' Equity."

Ownership interests may be represented by membership certificates or shares. For example, an LLC may issue Class I shares that have unlimited voting rights and Class II shares that have only limited rights and privileges. Different classes of shares may also have different rights as to the distribution of assets upon dissolution of the

company. If ownership interests are represented by membership certificates or shares, the equity section of the balance sheet will resemble that of a corporation.

If ownership interests are not represented by membership certificates or shares, the equity section of the balance sheet will resemble that of a partnership. Generally, only a single amount will be shown. However, if it is desirable to disclose separately the equity accounts of those members who have been designated as managers, a presentation such as the following can be made:

MEMBERS' EQUITY	
Managing members	$ 75,000
Nonmanaging members	25,000
	$ 100,000

FASB ASC 272-10-45-3 states that the components of members' equity may be presented on the face of the balance sheet or in the notes.

The operating agreement of some LLCs may provide that unless the transfer (for example, by assignment or inheritance) of a member's interest is approved by the remaining members, the transferee will not be permitted to participate in the management of the LLC or become a member. Instead, the transferee is entitled only to receive the distributions to which the assigning member otherwise would be entitled. The authors believe that, if desired, the portion of members' capital owned by such non-approved transferees could also be disclosed.

FASB ASC 272-10-45-4 and 45-5 states that if a member's equity account is less than zero, a deficit should be reported even though the member's liability may be limited. In addition, if the LLC records amounts due from members for capital contributions, those amounts should be presented as deductions from members' equity rather than as assets.

Conversion of an Existing Entity to an LLC. LLCs frequently are formed when an existing entity is converted to an LLC. The converting entity often is a partnership. However, C corporations and S corporations may also merge with an LLC or convert to an LLC. An LLC formed by the conversion of a partnership generally is considered a continuation of the partnership, and no new taxable entity comes into being. However, the conversion of a corporation to an LLC classified as a partnership results in the creation of a new entity for tax purposes. (According to FASB ASC 250-10, a change in the legal form of business is not considered a change in reporting entity.) *PPC's Guide to Preparing Financial Statements* provides guidance on the accounting issues surrounding the conversion of a corporation to a partnership.

Comparative Financial Statements. When one or more prior years' financial statements are presented after a change to an LLC, the question arises whether the prior year statements should be modified. As discussed in the previous paragraph, changes in the legal form of business, for example, from an S corporation or partnership to an LLC, are not changes in the reporting entity. Consequently, retrospective application is not appropriate. However, in order to enhance the comparability, it may be necessary to modify the format of the prior year statements. If that is done, a note such as the following can be included to disclose the change:

> NOTE X—RECLASSIFICATIONS
>
> Certain accounts in the prior-year financial statements have been reclassified for comparative purposes to conform with the presentation in the current-year financial statements.

As a practical matter, especially when a corporation is converted to an LLC classified as a partnership, accountants may choose to recommend that their LLC clients present single-period statements for the first reporting period following the change.

While changing the legal form of an entity to an LLC does not constitute a change in reporting entity, formation of an LLC may in some cases result in a change in reporting entity. For example, if commonly-owned companies for which combined financial statements had not previously been presented were combined into a single LLC, a change in

reporting entity would occur. In that case, the disclosures required by FASB ASC 250-10 should be made and the change should be retrospectively applied to the financial statements for all prior periods presented.

LLC Financial Statement Disclosure Requirements. An LLC needs to disclose the following:

- A description of any limitation of members' liability. (The identification of the entity as an LLC classified as a partnership alerts financial statement readers to the general limitation of members' liability. Therefore, the authors believe the additional requirement of FASB ASC 272-10-50-3 to describe limitations only relates to *special* limitations, such as those imposed by some states on the managing member's liability or the special liability considerations for members of professional limited liability entities.)
- The amount of each class of members' interests if more than one class exists, each having varying rights, preferences, and privileges of each class. [As previously discussed, if the LLC does not report the equity amount of each class separately in the equity section of the balance sheet, the equity amounts must be disclosed in the notes (FASB ASC 272-10-50-1).]
- The date the LLC will cease to exist if it has a finite life.
- The separate components of members' equity, such as undistributed earnings, earnings available for withdrawal, or unallocated capital, if the LLC maintains such components. (This disclosure is permitted but not required.)
- The fact that the company's assets and liabilities previously were held by a predecessor entity or entities (for LLCs formed by combining entities under common control or by converting from another type of entity). These LLCs are also encouraged to make the relevant disclosures in FASB ASC 805-10-50-2.
- Any relevant income tax disclosures required by FASB ASC 740-10.

Disclosure of Change in Legal Form and/or Tax Status. The authors believe that disclosure of the change in legal form and/or tax status would also be made. Conversion of an existing entity to an LLC was discussed earlier.

Single-member LLCs. For accounting and reporting purposes, a single-member LLC would follow the rules for LLCs, not those of proprietorships. There may, however, be a few presentation differences that need to be considered. For example, for a single-member LLC, the report is addressed to the *member* of XYZ LLC versus to the *members* of XYZ LLC. In addition, the equity statement for a single-member LLC is called the "Statement of *Member's* Equity" versus the "Statement of *Members'* Equity." Accountants may also want to consider adding a footnote to single-member LLC statements noting that the statements do not include personal accounts (as in the case of a proprietorship).

LLC Taxed as an S Corporation. For U.S. GAAP financial statement reporting purposes, an LLC being taxed as an S corporation will follow the accounting and presentation rules for an LLC, with the exception of the financial statement tax footnote that will discuss the S corporation taxing rules. However, if the client uses the tax basis of accounting for financial statement purposes, the S corporation accounting and presentation rules are followed.

CONSIDERATIONS FOR LIMITED LIABILITY PARTNERSHIPS

Limited liability partnerships (LLPs) are a special type of general partnership that exist under state laws. LLPs were enacted in response to the concern that a partner of a professional firm can be held liable for the malpractice of another partner in the same firm.

The partners in an LLP generally remain personally liable for their own acts and omissions, and the acts and omissions of persons under their supervision. However, LLP partners typically are not liable for acts and omissions by the other LLP partners or nonsupervised employees. In many states, the LLP statutes provide that LLP partners are not personally liable for the LLP's contract liabilities unless they are personally guaranteed. In such states, LLPs are similar to LLCs with regard to the issue of owner exposure to the entity's liabilities. State law must be consulted to determine the extent of an LLP partner's liability exposure.

Advantages and Disadvantages of LLPs

Advantages. The major advantages of LLPs are favorable pass-through taxation rules; the flexibility to structure ownership interests with varying rights to cash flow, liquidation proceeds, and tax allocations; and the low cost of converting to LLP status. Most states only require the filing of a registration statement and payment of a fee (which can be significant) to form an LLP. No new partnership agreement is required.

Disadvantages. The primary disadvantage of LLPs is the liability in some states of the partners for the debts and other obligations of the LLP (exclusive of liability for professional acts and omissions of others). Thus, an LLP sometimes provides its partners with less liability protection than is available to members of an LLC but more than is available under a general partnership. In addition, the annual registration fee in some states is significant and some states require significant levels of malpractice insurance.

LLPs Compared to LLCs. From a liability limitation standpoint, the use of an LLC is sometimes preferable to the use of an LLP. However, LLPs are available for professional practices in some states where LLCs are not.

The administrative aspects of adopting LLP status for a professional practice (for example, meeting the state board of accountancy rules) generally are minimal in comparison to obtaining permission to operate as an LLC, especially in the case of a multistate practice.

Accounting and Reporting Issues

Similar to LLCs, LLPs do not give rise to a significant number of accounting or reporting issues that differ from those of partnerships. FASB ASC 272-10 provides guidance on applying existing accounting literature to LLPs (as well as LLCs). In fact, FASB ASC 272-10 states in its guidance that the collective term "limited liability companies" includes both LLCs and LLPs. Therefore, the unique accounting and reporting issues for LLCs discussed in the previous section also apply to LLPs.

SELF-STUDY QUIZ

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

19. What is one advantage of a limited liability company (LLC)?

    a. They can have a limited life.

    b. The ease of transferring interests.

    c. Members are exempt from self-employment tax.

    d. One member is not liable for all of the entity's debts.

20. What is the purpose of an LLC's operating agreement?

    a. Determining the rights and powers of its members.

    b. Establishing the LLC within the state that it will operate.

    c. Ensuring compliance with the Uniform Limited Liability Company Act.

    d. Electing a different classification for the LLC.

SELF-STUDY ANSWERS

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

19. What is one advantage of a limited liability company (LLC)? **(Page 101)**

    a. They can have a limited life. [This answer is incorrect. Sometimes, LLCs have a limited life, such as by termination on the death or bankruptcy of a member. This is one of the disadvantages of using the LLC structure.]

    b. The ease of transferring interests. [This answer is incorrect. One of the disadvantages of LLCs is that the transfer of interests is more difficult.]

    c. Members are exempt from self-employment tax. [This answer is incorrect. One of the disadvantages of an LLC is that members who have management authority, debt responsibility, or who materially participate are exposed to self-employment tax.]

    d. **One member is not liable for all of the entity's debts. [This answer is correct. One advantage of operating as an LLC is that they have limited liability. This means that members generally are not personally liable for the LLC's debts or liabilities, except to the extent of their investment and any remaining capital commitment to the LLC.]**

20. What is the purpose of an LLC's operating agreement? **(Page 102)**

    a. **Determining the rights and powers of its members. [This answer is correct. The owners of an LLC are referred to as members, and their rights and powers are usually provided in the company's "operating agreement." The operating agreement is the LLC equivalent of a partnership agreement or corporate bylaws.]**

    b. Establishing the LLC within the state that it will operate. [This answer is incorrect. An LLC is established by filing articles of organization (not an operating agreement) with the appropriate state agency.]

    c. Ensuring compliance with the Uniform Limited Liability Company Act. [This answer is incorrect. Although there is a Uniform Limited Liability Company Act, not all states have adopted it as the model for state LLC statutes. However, whether or not a state uses the Uniform Limited Liability Company Act has no bearing on the information in an LLC's operating agreement. The operating agreement has a different focus.]

    d. Electing a different classification for the LLC. [This answer is incorrect. LLCs wishing to elect a classification different from their default classification (i.e., who wish to be classified as corporations) must make an election on Form 8832 (Entity Classification Election). The same is true when an LLC later wishes to change its existing classification. However, the purposes of Form 8832 and an LLC's operating agreement are different.]

Lesson 3: S Corporations

INTRODUCTION

Because they are viewed legally as corporations, authoritative literature has not addressed accounting, presentation, and reporting issues of S corporations separate from those of conventional corporations (hereafter referred to as "C corporations"). For most general ledger account groupings, the accounting treatment is, indeed, the same as that for a C corporation. However, for the federal income tax (normally absent in S corporations) and retained earnings account groupings, subtle and sometimes major differences are caused by the unique federal income tax treatment of S corporations.

With the liability protection and pass-through taxation they provide, S corporation status is the more common of the possible business structures. Therefore, accountants should be aware of the unique accounting issues of S corporations. This lesson explores these issues and develops guidance based on (a) the Subchapter S Revision Act of 1982 and subsequent amendments, acts, and technical corrections affecting that guidance, (b) logical extensions and inferences of GAAP, and (c) state corporation law. Much of GAAP for shareholders' equity is traditional and taken from leading textbooks. Discussions relating to state corporation law are based on the Model Business Corporation Act that has been adopted, at least in part, in most states. Because corporation law may vary among states, procedures presented in this lesson may require adaptation to conform to a particular state's law.

LLC Taxed as an S Corporation

For U.S. GAAP financial statement reporting purposes, an LLC taxed as an S corporation will follow the accounting and presentation rules for an LLC, with the exception of the tax footnote that discusses the S corporation taxing rules. However, if the client uses a tax basis for financial statement purposes, the S corporation accounting and presentation rules should be followed.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize appropriate presentation for S corporations and retained earnings.
- Identify losses, tax/book differences, and termination of a retained earnings account.

THE FINANCIAL STATEMENT PRESENTATION

Balance Sheet

The balance sheet of an S corporation is the same as for a C corporation. Accordingly, the balance sheet should generally report a single retained earnings amount. The components of retained earnings can be disclosed in the notes to financial statements or in a separate statement of retained earnings if the information would be meaningful to the users.

Statement of Income

The details of the statement are the same as for a C corporation except that, as a general rule, no federal income tax expense is reported. A supplementary schedule showing the allocation of taxable income to shareholders and reconciling the total taxable income to net income can be used to provide additional informative disclosures to shareholders. See Exhibit 3-4 for an illustration.

Statement of Retained Earnings

Although not required by GAAP as explained above, some accountants use a statement of retained earnings to disclose the changes in components of retained earnings of S corporations. Each component of retained earnings can be identified separately with disclosure of its beginning balance, transactions or events that caused changes, and ending balance. As an alternative to this statement, disclosure is sometimes made in the notes.

Statement of Comprehensive Income

The statement of comprehensive income of an S corporation is the same as for a C corporation. See the discussion on reporting comprehensive income in Lesson 1. Regardless of the method used, the statement displaying comprehensive income must include net income, the components of other comprehensive income, and a total comprehensive income amount.

Statement of Cash Flows

This statement is the same as for a C corporation.

Comparative Financial Statements

When one or more prior years' statements are presented after a change to or from S corporation status, the question arises whether prior year statements should be modified. A change in the legal form of business is not a change in reporting entity according to FASB ASC 250. Also, FASB ASC 250 implies that a change to or from S corporation status is not viewed as a change in accounting principle. Therefore, retrospective application is inappropriate. However, in order to enhance comparability, it may be necessary to modify the format of the C corporation's income statements to focus on income before taxes as well as on net income. Disclosure of the change in legal form and/or tax status should also be made.

Summary of Unique Disclosures

The following are the authors' recommendations for disclosures that are unique to S corporations (this list may not be all-inclusive):

a. The S corporation status of the corporation should be disclosed either in the notes or the accountant's report. The authors' policy is to disclose the S corporation status parenthetically in the accountant's report.

b. A description of the tax consequences of the S corporation election should be presented in the notes. Sample wording follows.

> NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
>
> Income taxes
>
> The Company has elected to be taxed under the provisions of Subchapter S of the Internal Revenue Code. Under those provisions, the Company does not pay federal corporate income taxes on its taxable income (. . . is not allowed a net operating loss carryover or carryback as a deduction). Instead, the stockholders are liable for individual federal income taxes on their respective shares (. . . include their respective shares of the Company's net operating loss in their individual income tax returns).

c. Distributions made after the S corporation election terminates, e.g., special post-termination distributions of the *Accumulated Adjustments Account* (defined in the next section) should be disclosed as a subsequent event.

d. If there is a danger that the S election could be retroactively terminated by the IRS, the contingency (federal income taxes) should be evaluated in the context of FASB ASC 450. Consideration should also be given to FASB ASC 740.

e. Although not required, the amount of accumulated earnings not distributed but previously taxed to the stockholders (AAA as defined in the next section) is sometimes disclosed.

f. Although not required, the details of the various retained earnings accounts are sometimes disclosed in the statement of retained earnings or in a note.

S Corporation Tax Uncertainties

FASB ASC 740-10 clarifies that if income taxes paid by the entity are attributable to the—

a. entity, they should be accounted for following the provisions of FASB ASC 740.

b. owners, they should be accounted for as a transaction with owners.

For example, a state that recognizes the Subchapter S election may nevertheless require the entity to pay an amount computed by applying the state income tax rate to the entity's taxable income allocated to an out-of-state owner. The individual would include the allocated income in his return and recognize a tax credit for the payment by the entity. The payment should be considered attributable to the owner and shown as a dividend or a stockholder distribution in the entity's financial statements.

FASB ASC 740-10 also clarifies that—

a. the determination of attribution should be made for each jurisdiction where the entity is subject to income taxes and determined on the basis of laws and regulations of the jurisdiction, and

b. management's determination of the taxable status of the entity, including its status as a pass-through entity, is a tax position that is subject to consideration of uncertainty.

To illustrate the accounting considerations, assume that a corporation that has elected Subchapter S status takes the position that it does not have nexus with a state that does not recognize that election. The corporation should evaluate whether the position would more likely than not be sustained by the state in an examination. That evaluation should consider the positions taken by the state in applying nexus requirements, such as how many years are considered open if tax would be assessed retrospectively and whether the state has adopted thresholds of taxable income attributable to the state below which it will not assert nexus.

As a practical matter, the authors believe the entity should also consider the materiality of the effects of the position being denied. For example, reallocation of taxable income to the state may enable the entity to reduce taxable income originally allocated to other states, resulting in recovery of state income taxes paid.

Finally, FASB ASC 740-10 clarifies that the reporting entity must consider the tax positions of all entities within the group of entities whose financial results are presented in consolidated or combined financial statements. To illustrate the accounting considerations, assume that a S corporation has a controlling financial interest in a C corporation that has not elected Subchapter S status. Since the S corporation has a controlling financial interest in the C corporation, it must include the consolidated financial results of the C corporation in its financial statements. The tax positions taken by the C corporation are subject to the requirements of FASB ASC 740-10 in determining whether income taxes for *the corporation* should be recognized in the consolidated financial statements.

PROCEDURES FOR RETAINED EARNINGS ACCOUNTING

General Requirements

Although accountants may show a single balance sheet caption and amount for retained earnings of an S corporation, the authors believe that maintenance of separate retained earnings accounts in the books is good accounting practice for the following reasons:

a. Maintenance of separate retained earnings accounts is generally necessary for proper tax accounting of an S corporation.

b. More often than not, the primary users of financial statements of S corporations are shareholders who are interested in the impact of the corporate earnings on their personal tax returns.

Terminology and Definitions

Because many of the terms and concepts of S corporation accounting have novel and specific meanings, it is helpful to clarify them before describing accounting procedures. The following definitions of terms and associated abbreviations are used throughout the remainder of this lesson.

a. *Accumulated Adjustments Account (AAA).* An amount defined by federal tax regulations that reflects the aggregate amount of undistributed income and gains (net of deductions) that have been taxed to the shareholders after 1982. The AAA is increased by taxable income and by separately stated items of income such as net capital gains; it is *not* increased by tax-exempt income. The AAA is reduced by tax losses and separately stated items of deduction such as charitable contributions and net capital losses, and it is also reduced by such nondeductible items as fines and penalties. However, expenses related to tax-exempt income do *not* reduce the AAA. Distributions paid to shareholders (that are not taxable dividends) reduce the AAA to the extent that such distributions do not exceed the adjusted AAA balance at year-end (before considering distributions for the year). The amounts included in the AAA also affect the shareholders' tax bases in the shares.

   For C corporations, distributions made to shareholders are first treated as taxable dividends to the extent of current or accumulated earnings and profits. However, when an S corporation converts to a C corporation, some of the distributions may still be nontaxable returns of income that was already taxed to the shareholders if made during the post-termination transition period (PTTP) if there is a sufficient AAA balance. In addition, if any AAA remains after the PTTP, a prorated portion of any distributions are allocated to the remaining AAA for certain eligible S corporations that revoke their S election under the Tax Cuts and Jobs Act.

b. *Accumulated Earnings and Profits (AEP).* An amount defined by federal tax regulations that applies to S corporations with previous Subchapter C status; it generally does not apply to corporations that immediately elect S corporation status. AEP generally represents retained earnings existing when S corporation status is attained, with certain adjustments required by the federal tax regulations [for example, in calculating AEP, straight-line depreciation (i.e., the alternative depreciation system) must be used in place of accelerated depreciation methods]. AEP may be reduced only by dividends to shareholders after the AAA has been distributed, unless the corporation elects otherwise as provided by the income tax rules. No new AEP may be generated by S corporations (unless another corporation with AEP is merged). Distributions of AEP do not reduce the shareholders' tax bases in the shares.

   AEP will be negative if past C corporation losses exceed income; negative AEP does not affect the tax status of future distributions to shareholders. However, its existence may limit the total amount of dividends that may be declared because of state laws. Negative AEP remains on the books indefinitely.

c. *Tax Temporary Adjustments (TTA).* A term developed for this lesson to represent retained earnings changes that result when tax/book differences originate and then reverse. Such differences are not recognized for tax purposes in the AAA and AEP calculations. Unlike other retained earnings (see item d.), TTA are not viewed as part of shareholders' tax bases in their shares. The use of the TTA account is necessary to maintain a double-entry financial accounting system while maintaining the AAA, AEP, and shareholders' bases at amounts recognized for tax purposes. This account will usually return to zero when timing differences completely reverse. In some cases, though, TTA will remain on the books indefinitely, particularly if the status of the S corporation changes.

d. *Other Retained Earnings (ORE).* Any amount that would be viewed as retained earnings under GAAP and state corporation law that is included in shareholders' bases for tax purposes, but is not included in the specific definitions above. The amount of ORE is increased by tax-exempt income and is reduced by expenses incurred to generate this tax-exempt income and by dividends paid to shareholders in excess of aggregate distributions from the AAA and AEP. Although this account is treated as paid-in capital for tax purposes, i.e., the items affect the shareholders' bases, GAAP and state corporation law imply that it should be viewed as retained earnings for accounting purposes.

The ORE generally tracks changes in the other adjustments account (OAA), which is maintained for tax purposes. [For a comprehensive discussion of the OAA, see the IRS instructions to Form 1120-S relating to Schedule M-2, column (d).] However, as discussed in the previous paragraph, the ORE is a broader account maintained for financial accounting purposes.

The next several sections of this lesson describe and illustrate accounting procedures designed to maintain these separate components of retained earnings for tax purposes and yet in total equal GAAP retained earnings.

TRACKING SEPARATE RETAINED EARNINGS ACCOUNTS

Although separate retained earnings accounts may be maintained, the balance sheet of an S corporation generally reflects a single retained earnings account. As noted previously, there is no requirement to disclose separate retained earnings accounts. Consequently, many accountants do not do so. As a result, the examples in the following sections illustrate the accounting entries tracking the separate retained earnings accounts, but do not illustrate separate statements of retained earnings.

Accounting procedures for tracking retained earnings of S corporations are illustrated by considering hypothetical companies reflecting different situations (the year, 20X4):

a. Brand NU Company, a newly formed corporation that elected S corporation status on January 1, 20X4.

b. Ceecorp Company, a previously existing conventional corporation that elected S corporation status on January 1, 20X4.

Each firm has four 25% shareholders: Mr. Able, Ms. Baker, Dr. Cole, and Mr. Dale. Each corporation uses the calendar year for tax and financial reporting purposes.

Procedures for Newly Formed S Corporations

Selected accounts from the Brand NU Company adjusted trial balance as of December 31, 20X4, are presented in Exhibit 3-1. During the accounting period following incorporation and election, the company has recorded transactions and made adjusting entries in accordance with GAAP. Distributions of $60,000 paid during the period are recorded in an account titled "Dividends."

Exhibit 3-1

Selected Accounts from Adjusted Trial Balance

BRAND NU COMPANY
ADJUSTED TRIAL BALANCE
December 31, 20X4
(Selected Accounts Only)

	Debit	Credit
Retained earnings		$ 0
Sales		2,000,000
Cost of goods sold	$ 1,200,000	
Officer and employee salaries	250,000	
Operating expenses	350,000	
State income taxes	40,000	
Officer life insurance premiums	30,000	
Interest income (tax exempt)		50,000
Dividends	60,000	

The various revenue and expense accounts are closed to an income summary account at the end of the accounting period. The entry to record income would be as shown in Exhibit 3-2. The $180,000 balance in the income summary

account represents net income as computed under GAAP. Taxable income that flows through to shareholders, however, is only $160,000 because of the $20,000 net permanent difference between tax-exempt interest income ($50,000) and nondeductible officer life insurance premiums ($30,000). The taxable income of $160,000 is credited to the AAA, and the $20,000 difference between tax-exempt income and nondeductible life insurance premiums is credited to ORE. The dividends of $60,000 are less than taxable income and would thus be deducted entirely from the AAA. If tax/book timing differences exist, a third retained earnings account (TTA) is necessary as discussed in a later section. Closing entries to allocate income and dividends to retained earnings are shown in Exhibit 3-3.

Exhibit 3-2

Entry to Record Income Summary

	DR	CR
Sales	$ 2,000,000	
Interest income (tax exempt)	50,000	
Cost of goods sold		$ 1,200,000
Officer and employee salaries		250,000
Operating expenses		350,000
State income taxes		40,000
Officer life insurance premiums		30,000
Income summary		180,000

Exhibit 3-3

Closing Entries

	DR	CR
Income summary	$ 180,000	
Retained earnings—AAA		$ 160,000
ORE		20,000
Retained earnings—AAA	60,000	
Dividends		60,000

Accountants may wish to present, as supplementary information, a schedule of income allocation similar to Exhibit 3-4, which reconciles net income and taxable income allocated to shareholders. Such presentations are useful to shareholders in understanding the relationship of the financial statement income of the company to their personal tax consequences.

Exhibit 3-4

Schedule of Income Allocation

BRAND NU COMPANY
SCHEDULE OF INCOME ALLOCATION
Year Ended December 31, 20X4

TAXABLE INCOME ALLOCATED TO SHAREHOLDERS		
Able		$ 40,000
Baker		40,000
Cole		40,000
Dale		40,000
	TOTAL TAXABLE INCOME	160,000
TAX-EXEMPT INCOME		50,000
NONDEDUCTIBLE EXPENSES		(30,000)
	NET INCOME	$ 180,000

See accountant's report.

Recommended disclosures for S corporation financial statements were summarized earlier in this lesson.

Procedures for Previous Conventional Corporations

Selected accounts from Ceecorp Company's adjusted trial balance at December 31, 20X4, are shown in Exhibit 3-5. The conventional corporate retained earnings account at December 31, 20X3, in the amount of $100,000, became AEP on January 1, 20X4. (This example ignores tax/book temporary differences arising before S corporation status is attained. These differences are discussed later in this lesson.)

Exhibit 3-5

Selected Accounts from Adjusted Trial Balance

CEECORP COMPANY
ADJUSTED TRIAL BALANCE
December 31, 20X4
(Selected Accounts Only)

	Debit	Credit
Retained earnings—AEP		$ 100,000
Sales		2,000,000
Cost of goods sold	$ 1,200,000	
Officer and employee salaries	300,000	
Operating expenses	461,000	
State income taxes	2,000	
Officer life insurance premiums	30,000	
Interest income (tax exempt)		50,000
Dividends	6,000	

The revenue and expense accounts are closed to the income summary account as shown in Exhibit 3-6 with a resulting net income computed under GAAP of $57,000.

Exhibit 3-6

Entry to Record Income

	DR	CR
Sales	$ 2,000,000	
Interest income (tax exempt)	50,000	
Cost of goods sold		$ 1,200,000
Officer and employee salaries		300,000
Operating expenses		461,000
State income taxes		2,000
Officer life insurance premiums		30,000
Income summary		57,000

Income would be allocated as shown in Exhibit 3-7. The $37,000 taxable income would flow through to the shareholders. This amount is recorded as the AAA. The $50,000 of tax-exempt interest income less the nondeductible life insurance premiums of $30,000 becomes part of ORE because this amount is added directly to shareholders' bases in the shares. If tax/book timing differences exist, adjustments of the AAA and ORE accounts are necessary. This topic is discussed later in this lesson.

Exhibit 3-7

Closing Entry to Allocate Income to Retained Earnings

	DR	CR
Income summary	$ 57,000	
Retained earnings—AAA		$ 37,000
ORE		20,000

Assume that Ceecorp had a poor financial year in 20X4, so that only $6,000 in distributions were paid—$1,500 to each shareholder. This amount is less than taxable income; hence, it reduces only the AAA as shown in Exhibit 3-8.

Exhibit 3-8

Closing Entry to Allocate Dividends to Retained Earnings

	DR	CR
Retained earnings—AAA	$ 6,000	
Dividends		$ 6,000

SELF-STUDY QUIZ

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

21. Which of the following basic financial statements is generally presented differently for an S corporation than it would be for a C corporation?

    a. The balance sheet.

    b. The statement of income.

    c. The statement of comprehensive income.

    d. The statement of cash flows.

22. What is the *accumulated adjustment account* (AAA)?

    a. The amount of retained earnings existing when S corporation status is elected by the entity.

    b. The amount of changes in retained earnings that result from tax/book differences that originate and then reverse.

    c. An amount that reflects aggregated undistributed income and gains taxed to shareholders after 1982.

    d. Any amount viewed as retained earning under GAAP and included in shareholder basis but excluded from other earnings definitions.

SELF-STUDY ANSWERS

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

21. Which of the following basic financial statements is generally presented differently for an S corporation than it would be for a C corporation? **(Page 109)**

    a. The balance sheet. [This answer is incorrect. The balance sheet of an S corporation is the same as for a C corporation.]

    b. **The statement of income. [This answer is correct. The details of the statement of income presented by an S corporation are the same as for a C corporation except that, as a general rule, no federal income tax expense is reported. A supplementary schedule showing the allocation of taxable income to shareholders and reconciling the total taxable income to net income can be used to provide additional informative disclosures to shareholders.]**

    c. The statement of comprehensive income. [This answer is incorrect. The statement of comprehensive income of an S corporation is the same as for a C corporation. Regardless of the method used, the statement displaying comprehensive income must include net income, the components of other comprehensive income, and a total comprehensive amount.]

    d. The statement of cash flows. [This answer is incorrect. The statement of cash flows for an S corporation is the same as that for a C corporation. Therefore, there is a better answer choice to this question.]

22. What is the *accumulated adjustment account* (AAA)? **(Page 112)**

    a. The amount of retained earnings existing when S corporation status is elected by the entity. [This answer is incorrect. *Accumulated earnings and profits* (AEP), not AAA, generally represents retained earnings existing when S corporation status is attained, with certain adjustments required by the federal tax regulations.]

    b. The amount of changes in retained earnings that result from tax/book differences that originate and then reverse. [This answer is incorrect. *Tax temporary adjustments* (TTA) is a term developed for this course to represent retained earnings changes that result when tax/book differences originate and then reverse. Such differences are not recognized for tax purposes in the AAA and AEP calculations.]

    c. **An amount that reflects aggregated undistributed income and gains taxed to shareholders after 1982. [This answer is correct. The AAA is an amount defined by federal tax regulations that reflects the aggregate amount of undistributed income and gains (net of deductions) that have been taxed to an S corporation's shareholders after 1982.]**

    d. Any amount viewed as retained earning under GAAP and included in shareholder basis but excluded from other earnings definitions. [This answer is incorrect. *Other retained earnings* (ORE) is a term for any amount that would be viewed as retained earnings under GAAP and state corporation law that is included in shareholders' bases for tax purposes but is not included in the other specific definitions provided in this lesson (AAA, AEP, and TTA).]

THE EFFECT OF LOSSES ON RETAINED EARNINGS ACCOUNTS

S corporation losses passed through to shareholders are deductible to the extent of shareholders' adjusted bases in the corporation's stock plus debt due them from the corporation. Losses that exceed shareholders' stock and debt bases are carried over indefinitely, to be used when stock or debt basis is increased. Basis will increase when the corporation has profits, the shareholder contributes capital, or the shareholder makes loans to the corporation.

Accounting procedures for S corporation losses parallel the procedures previously illustrated for profits. The AAA is reduced (debited) for the amount of loss that is passed through to the shareholders. The AAA is also reduced for nondeductible expenses not related to tax-exempt income. Tax-exempt income less related expenses is credited to ORE. AEP accounts are not affected by S corporation losses. The AAA may carry a debit balance as a result of losses. Distributions made while the AAA has a debit balance would be made from AEP, assuming that total retained earnings has a credit balance. If total retained earnings amounts to a deficit, dividends cannot normally be legally declared even though AEP may have a credit balance. State corporation law generally recognizes retained earnings as a single amount.

To illustrate loss accounting procedures, refer to the examples for Ceecorp Company for the year 20X4 (Exhibit 3-5 through Exhibit 3-8). Procedures are essentially the same for all S corporations; hence, they are not illustrated separately. At the end of 20X4, Ceecorp has AAA with a $31,000 balance and ORE with a $20,000 balance. Assume that shareholders had paid $40,000 ($10,000 each) for their shares. Therefore, shareholders' bases in the shares would be $91,000 ($22,750 each). Also assume that Dr. Cole has a note payable from the corporation of $5,000.

Assume further that Ceecorp realizes a net loss of $200,000 in 20X5, and that there are no tax/book differences. In this case, the income summary account would have a debit balance of $200,000. The entry to close the net loss is shown in Exhibit 3-9. As a result, the AAA now has a debit balance of $169,000. The capital stock, paid-in capital, and notes payable accounts are not reduced because these items are not legally canceled.

Exhibit 3-9

Closing Entry to Allocate Net Loss to Retained Earnings

	DR	CR
Retained earnings—AAA	$ 200,000	
Income summary		$ 200,000

The entire $200,000 loss is allocated to shareholders ($50,000 each). The maximum loss that can be deducted by the shareholders in 20X5, however, is $96,000 ($22,750 each to Able, Baker, and Dale, and $27,750 to Cole). The remaining $104,000 loss is suspended at the individual shareholder level and can be deducted in future years, but only after the shareholders' basis has increased. (Disclosure of the future tax effect for shareholders should be considered.)

THE EFFECT OF TAX/BOOK DIFFERENCES ON RETAINED EARNINGS ACCOUNTS

S corporations do not normally pay federal income taxes and thus do not report federal tax liabilities and deferred taxes. Nevertheless, it may be necessary to record originating and reversing tax/book temporary differences because these differences affect the various retained earnings accounts and sometimes require that additional retained earnings accounts be established. The accounting procedures vary depending on the origin of the S corporation and whether the temporary differences originated before or after S corporation status was attained.

Many tax/book differences originate with income under GAAP in excess of taxable income. Therefore, the following discussions and illustrations incorporate this presumption. All of the illustrations are based on the following data: assume that during 20X4, a company purchased assets for $50,000. For tax purposes, the cost will be recovered

using three-year MACRS. For accounting purposes, the company records straight-line depreciation over five years with no residual value. A summary of the relevant data is as follows:

Year	Cost Recovered		Depreciation		Difference	Cumulative Difference
20X4	$ 16,665	(33.33%)	$ 10,000	(20%)	$ 6,665	$ 6,665
20X5	22,225	(44.45%)	10,000		12,225	18,890
20X6	7,405	(14.81%)	10,000		(2,595)	16,295
20X7	3,705	(7.41%)	10,000		(6,295)	10,000
20X8	—		10,000		(10,000)	—
TOTALS	$ 50,000		$ 50,000		$ -0-	

Differences Originating after S Corporation Status Is Attained

To illustrate accounting procedures for newly created corporations that immediately elect S corporation status, refer to the adjusted trial balance for Brand NU Company for the year 20X4 in Exhibit 3-1 and assume:

a. Depreciation expense of $10,000 is included in operating expenses.

b. GAAP net income for 20X4 is $180,000.

c. GAAP net income includes $50,000 of nontaxable income and $30,000 of nondeductible expenses.

d. Taxable income for 20X4 is $153,335 ($180,000 GAAP income – $6,665 excess MACRS depreciation – $50,000 nontaxable income + $30,000 nondeductible expenses).

When closing the income summary account, it is necessary to use an additional retained earnings account called TTA to record the tax/book temporary difference. This is illustrated in Exhibit 3-10.

Exhibit 3-10

Closing Entry to Allocate Income to Retained Earnings

	DR	CR
Income Summary	$ 180,000	
Retained earnings—AAA		$ 153,335
ORE		20,000
Retained earnings—TTA		6,665

The amount of TTA represents taxable income that will be allocated to shareholders in future years and thus should be disclosed separately. The supplementary schedule of income allocation for 20X4 is shown in Exhibit 3-11. An explanatory note, describing the nature of material differences between book and taxable income, is recommended by the authors.

Exhibit 3-11

Supplementary Schedule of Income Allocation

BRAND NU COMPANY
SCHEDULE OF INCOME ALLOCATION
Year Ended December 31, 20X4

TAXABLE TO SHAREHOLDERS IN 20X4		
Able		$ 38,334
Baker		38,334
Cole		38,334
Dale		38,333
	TOTAL TAXABLE INCOME	153,335
TAXABLE TO SHAREHOLDERS IN FUTURE YEARS		6,665
TAX-EXEMPT INCOME		50,000
NONDEDUCTIBLE EXPENSES		(30,000)
	NET INCOME	$ 180,000

See accountant's report.

Assume net income computed under GAAP for years 20X5 through 20X8 is as follows:

20X5	$ 200,000
20X6	250,000
20X7	150,000
20X8	190,000

Assume further that there are no tax/book differences except for the difference between cost recovery and straight-line depreciation expense. Entries to close net income for each of these years are presented in Exhibit 3-12. Observe that the TTA account is reduced to zero when the temporary difference completely reverses in 20X8.

Exhibit 3-12

Entries to Close Net Income to Retained Earnings

	DR	CR
20X5 Income summary	$ 200,000	
Retained earnings—TTA		$ 12,225
Retained earnings—AAA		187,775
20X6 Income summary	250,000	
Retained earnings—TTA	2,595	
Retained earnings—AAA		252,595
20X7 Income summary	150,000	
Retained earnings—TTA	6,295	
Retained earnings—AAA		156,295
20X8 Income summary	190,000	
Retained earnings—TTA	10,000	
Retained earnings—AAA		200,000

Differences Originating before S Corporation Status Is Attained

Tax/book temporary differences originating before S corporation status is attained produce some interesting questions:

a. How should pre-S corporation temporary differences be reflected in the retained earnings accounts?

b. How should the reversal of these pre-S corporation differences be recorded?

c. What should be done with existing deferred taxes, if any?

Because temporary differences produce a difference between GAAP income and taxable income, the GAAP retained earnings will differ from the tax concept of AEP for C corporations.

At the time of conversion to S corporation status, AEP, as defined for tax purposes, is frozen. The authors believe that the GAAP retained earnings balance should be segregated into two or more parts at the time a corporation converts to an S corporation.

a. *AEP.* As defined for tax purposes.

b. *TTA.* The net temporary differences.

c. *ORE.* Permanent differences, etc., that do not enter the calculation of AEP.

These separate component accounts for retained earnings preserve the tax concept of AEP yet maintain a GAAP retained earnings balance.

Although the temporary differences originating before attaining S corporation status will reverse, they will not generate a tax liability so long as S corporation status is maintained. Thus, deferred taxes previously recorded will not become due. FASB ASC 740 requires that existing deferred tax assets and liabilities be eliminated through a charge or credit to income tax expense for the period in which the enterprise ceases to be a taxable enterprise.

Because the concept of a TTA account is not commonly known, many existing S corporations may include within their various retained earnings accounts elements of tax/book differences and/or deferred taxes. The authors suggest establishing a TTA account and reallocating within the retained earnings accounts any material amounts of tax/book differences. This will allow the accounting records to properly reflect GAAP and yet maintain retained earnings accounts for the tax concepts of AEP, AAA, etc.

Tax/Book Differences Existing When S Corporation Status Terminates

Tax/book temporary differences existing when S corporation status terminates are discussed in the next section.

Tax Basis of Accounting

Converting from GAAP to the tax basis of accounting at the time of conversion to S corporation status will eliminate the need to account for tax/book temporary differences. Accountants should consider this option in light of the intended uses of the financial statements.

THE EFFECT OF TERMINATION OF THE S CORPORATION ELECTION ON RETAINED EARNINGS ACCOUNTS

When an S corporation election is terminated, it is necessary for financial accounting purposes to merge retained earnings items that have resulted from income that has flowed through and been taxed to shareholders (AAA) with ORE. The merged retained earnings account should then be separated from retained earnings such as AEP that have resulted from earnings that were taxable to the corporation. Distributions from the former are generally viewed as tax-free returns of capital for tax purposes, whereas distributions from the latter are generally taxable to shareholders as are any other dividends.

When a corporation terminates its S corporation election, it has a specified period during which it can distribute all of the AAA. Any AAA *not* distributed becomes part of ORE. Alternatively, the corporation (to avoid the accumulated earnings tax or personal holding company tax) can elect to have all of its distributions during this period taxed as dividends and not reduce the basis of the shares. If this treatment is elected, the distribution is recorded as a debit to AEP. In subsequent periods, once S corporation status has ended, all income becomes part of AEP, and any dividends paid must first come from AEP before tax-free distributions can be made from ORE. It is beneficial, therefore, for the corporation to reduce the AAA by the maximum extent possible during the post-termination period through distributions, considering its cash position and borrowing ability. Otherwise, the AAA could be effectively "frozen" when it becomes ORE.

General Accounting Procedures

To illustrate accounting procedures, assume that management of Term Company, an S corporation with the same ownership structure as described earlier in this lesson (in the section on tracking separate retained earnings accounts), terminated its S corporation election on July 1, 20X6. The adjusted trial balance for the year 20X6 is presented in Exhibit 3-13. Note that retained earnings amounts are beginning-of-year amounts. It is assumed that the distributions of $200,000 were paid before September 15, 20X6, and that this amount was the largest possible reduction in the AAA based on the company's financial position. The company filed a short-year tax return as an S corporation on September 15, 20X6, covering the period January 1 through June 30, 20X6. It will file another short-year return as a conventional corporation on April 15, 20X7, for the period July 1 through December 31, 20X6. It made no additional distributions in 20X6.

Exhibit 3-13

Selected Accounts from Adjusted Trial Balance

TERM COMPANY
ADJUSTED TRIAL BALANCE
December 31, 20X6
(Selected Accounts Only)

	Debit	Credit
Retained earnings—AAA		$ 250,000
Retained earnings—AEP		200,000
ORE		90,000
Sales		2,000,000
Cost of goods sold	$ 1,200,000	
Operating expenses	580,000	
Federal income taxes	40,000	
Dividends	200,000	

The company did not close its books when it terminated its S corporation election, but it did calculate its taxable income through June 30, 20X6, to be $120,000. There are no tax/book differences for the year. Taxable income for the period July 1 to December 31 is $100,000. Therefore, income before taxes for the year is $220,000. Tax expense for the last half of the year is $40,000 (assume a 40% tax rate). Net income would thus be $180,000 ($120,000 + $100,000 – $40,000). The entry to allocate income to retained earnings is shown in Exhibit 3-14. Earnings after June 30, 20X6, are recorded as increases of AEP because they are taxable to the corporation.

Exhibit 3-14

Closing Entry to Allocate Income to Retained Earnings

	DR	CR
Income summary	$ 180,000	
Retained earnings—AAA		$ 120,000
Retained earnings—AEP (100,000 – 40,000)		60,000

Distributions, although after termination of S corporation status, are within the post-termination period, and thus are not distributions of the C corporation's earnings but instead reduce the AAA. Exhibit 3-15 illustrates the entry to record the distributions.

Exhibit 3-15

Entry to Record Distributions

	DR	CR
Retained earnings—AAA	$ 200,000	
Dividends		$ 200,000

An additional entry is needed as shown in Exhibit 3-16 to merge the undistributed portion of the AAA into ORE.

Exhibit 3-16

Entry to Merge AAA into ORE

	DR	CR
Retained earnings—AAA (250,000 + 120,000 – 200,000)	$ 170,000	
ORE		$ 170,000

Tax rules require that in subsequent years all distributions be allocated first to AEP. Consequently, pre-termination earnings that have been merged and reported as ORE cannot be distributed until all AEP is exhausted. In practice, however, it may be impossible to distribute AEP without impairing the financial condition of the company. Pretermination earnings of terminated S corporations may thus be effectively frozen.

Because federal tax rules view ORE as paid-in capital, a terminated S corporation may wish to transfer it to paid-in capital. State corporation law generally *permits* boards of directors to transfer retained earnings to paid-in capital but does not *require* such a transfer. If the board of directors of Term Company complies with state law and explicitly transfers ORE to paid-in capital, the accounting entry to record the transfer would be as shown in Exhibit 3-17. The resulting statement of retained earnings follows logically and is not illustrated. A note to the financial statements describing the transfer (not illustrated in this course) would normally be required to disclose the change in legal status to shareholders.

Exhibit 3-17

Entry to Transfer ORE to Paid-in Capital

	DR	CR
ORE	$ 260,000	
Additional paid-in capital from transfer of retained earnings		$ 260,000

A transfer of ORE to paid-in capital may give corporations less flexibility in managing its shareholders' equity because state corporation law generally places greater restrictions on paid-in capital than on retained earnings. Therefore, a terminated S corporation may choose not to make this transfer. If a transfer is not made, financial statements prepared in accordance with GAAP should continue to report pretermination earnings as ORE. Note disclosure would normally be required to inform shareholders that distributions from this item can be made tax free after other earnings have been distributed.

Tax/Book Differences and Termination

The procedures illustrated in the preceding paragraphs of this section illustrate how to account for AEP, AAA, and ORE in the event of termination of the S corporation election. If unreversed tax/book temporary differences exist, how should the TTA account be accounted for? The authors suggest closing the TTA account and transferring it to ORE. FASB ASC 740 requires the reinstatement of deferred tax assets and liabilities on existing differences.

COMPILATION AND REVIEW REPORTS FOR S CORPORATIONS

The only policy adopted by the authors as uniquely applicable to S corporations is that the S corporation status be disclosed in the accountant's report parenthetically after the name of the company.

SELF-STUDY QUIZ

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

23. Which of the following statements best describes how tax/book differences from before an entity attained S corporation status affect retained earnings?

    a. The corporation's AAA and ORE are frozen.

    b. The balance of GAAP retained earnings is segregated into AEP, TTA, and/or ORE.

    c. Taxes deferred upon S corporation status will come due within a specific time period.

    d. Existing deferred tax assets and liabilities cannot be eliminated.

24. Which of the following could occur when a corporation terminates its S corporation election?

    a. Retained earnings items from income are combined with AAA.

    b. It must distribute all of its AAA by a certain time or it will be reclassified.

    c. All distributions during the termination period can be taxed as dividends and the basis of shares reduced appropriately.

    d. In subsequent years, the terminated S corporation should allocate distributions to AAA first.

SELF-STUDY ANSWERS

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

23. Which of the following statements best describes how tax/book differences from before an entity attained S corporation status affect retained earnings? **(Page 122)**

    a. The corporation's AAA and ORE are frozen. [This answer is incorrect. At the time of conversion to S status, AEP, as defined for tax purposes (not AAA or ORE) is frozen.]

    b. **The balance of GAAP retained earnings is segregated into AEP, TTA, and/or ORE. [This answer is correct. The GAAP retained earnings balance can be segregated into two or more parts at the time a corporation converts to an S corporation: (1) AEP (as defined for tax purposes), (2) TTA (the net temporary differences), and (3) ORE (permanent differences, etc., that do not enter the calculation of AEP). These separate component accounts for retained earnings preserve the tax concept of AEP yet maintain a GAAP retained earnings balance.]**

    c. Taxes deferred upon S corporation status will come due within a specific time period. [This answer is incorrect. Although the temporary differences originating before attaining S corporation status will reverse, they will not generate a tax liability so long as S corporation status is maintained. Thus, deferred taxes previously recorded will not become due.]

    d. Existing deferred tax assets and liabilities cannot be eliminated. [This answer is incorrect. FASB ASC 740 requires that existing deferred tax assets and liabilities be eliminated through a charge or credit to income tax expense for the period in which the enterprise ceases to be a taxable enterprise.]

24. Which of the following could occur when a corporation terminates its S corporation election? **(Page 123)**

    a. Retained earnings items from income are combined with AAA. [This answer is incorrect. When an S corporation election is terminated, it is necessary for financial accounting purposes to merge retained earnings items from income that has flowed through and been taxed to shareholders (AAA) with ORE. The merged retained earnings account should then be separated from retained earnings such as AEP that have resulted from earnings that were taxable to the corporation. However, the retained earnings items discussed would not have to be combined with AAA because they *are* AAA.]

    b. **It must distribute all of its AAA by a certain time or it will be reclassified. [This answer is correct. When a corporation terminates its S corporation election, it has a specified period during which it can distribute all of the AAA. Any AAA not distributed becomes part of ORE.]**

    c. All distributions during the termination period can be taxed as dividends and the basis of shares reduced appropriately. [This answer is incorrect. To avoid the accumulated earnings tax or the personal holding company tax, the corporation can have all of its distributions during this period taxed as dividends, but then the basis of the shares would *not* be reduced.]

    d. In subsequent years, the terminated S corporation should allocate distributions to AAA first. [This answer is incorrect. Tax rules require that in subsequent years all distributions be allocated first to AEP. Consequently, pre-termination earnings that have been merged and reported as ORE cannot be distributed until all AEP is exhausted.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Compilation and Review Engagements—Course 1—Form and Presentation of Financial Statements, Partnerships, and S Corporations (CARTG211)

Testing Instructions

1. Following these instructions is an **Examination for CPE Credit** consisting of multiple choice questions. 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 those 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 the PDF and can be printed if needed.

2. **ONLINE GRADING.** Log onto our Online Grading Center at **cl.tr.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $109 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

3. **PRINT GRADING.** If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($109 for email or fax; $119 for regular mail). The answer sheet is found at the end of the **Examination for CPE Credit**. Answer sheets may be printed from the PDF; they can also be scanned to send via email, if desired. Each answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for the course. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

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

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

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     CARTG211 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

   If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

4. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($109 for answer sheets sent by email or fax; $119 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three

courses, the price for grading all three is $310 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $392 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $463 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

5. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **July 31, 2022**. CPE credit will be given for examination scores of 70% or higher.

6. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** and the **Self-study Course Evaluation** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy of the answer sheet for your records.

7. Please direct any questions or comments to our Customer Service department at (800) 431-9025 (Option 2).

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Compilation and Review Engagements—Course 1—Form and Presentation of Financial Statements, Partnerships, and S Corporations (CARTG211)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet is located at the end of the exam and can be printed out, if desired. Alternatively, it can be accessed by logging onto the Online Grading System.

1. When would a table of contents be the most useful to readers of a financial statement presentation?
    a. The financial statements are consolidated.
    b. Supplementary information is included.
    c. It is a single-statement presentation.
    d. It is a set of basic financial statements.
2. Does authoritative guidance require an accountant's report to be printed on firm letterhead?
    a. Yes, this is a requirement under the SSARS to use letterhead.
    b. Yes, but there is an exception when certain software packages are used.
    c. No, but the report must be manually signed by the accountant.
    d. No, but the use of letterhead is a best practice for professionalism.
3. After compiling her client's statements, Mary is preparing her accountant's report. Mary is a partner in a larger firm. Which of the following should she do?
    a. Title her report INDEPENDENT ACCOUNTANT'S REVIEW REPORT.
    b. Omit including an addressee since it is not an auditor's report.
    c. Include the city and state where Mary practices.
    d. Include a salutation, such as "Dear Gentlemen."
4. What is the correct term for when a balance sheet is presented on a single page with assets at the top and liabilities and stockholders' equity at the bottom?
    a. Account form.
    b. Report form.
    c. Multiple-step form.
    d. Single-step form.
5. What is the term for income that includes both net income and other income such as certain revenues, expenses, gains, and losses that are reported as a separate component of stockholders' equity?
    a. Comprehensive income.
    b. Component income.
    c. Recognized income.
    d. Accumulated income.

6. Which of the following should be done if an entity uses a single-statement format to report comprehensive income?

   a. Two sections should be used: net income and other comprehensive income.

   b. The information about comprehensive income should immediately follow the income statement.

   c. The statement of income should be called the "Statement of Net Income."

   d. Tax effects should be aggregated, not broken down by each component of comprehensive income.

7. How is the statement of retained earnings or changes in stockholders' equity affected when the reporting entity's liabilities exceed its assets?

   a. It will combine its statement of income and retained earnings.

   b. It will report a negative equity balance.

   c. It will disclose changes in retained earnings on the face of its balance sheet.

   d. It will need to be treated as a departure from GAAP.

8. The basic financial statement that illustrates the changes in cash, cash equivalents, and restricted cash and equivalents during the reporting period is called what?

   a. Balance sheet.

   b. Statement of income.

   c. Statement of comprehensive income.

   d. Statement of cash flows.

9. Mac-2 receives cash receipts from the sale of its services. How would that be classified on Mac-2's statement of cash flows?

   a. Cash receipts from operating.

   b. Cash receipts from investing.

   c. Cash receipts from financing.

   d. Noncash investing and financing transactions.

10. Most cash flows are required to be reported gross. Which of the following is permitted to be reported net instead?

    a. Proceeds from selling assets and cash payments for capital expenditures.

    b. Proceeds from long-term borrowings and repayments made on long-term obligations.

    c. Cash receipts and payments from selling and buying cash equivalents.

    d. Loans made by the entity and collections on loans.

11. To present its cash flows from operations, Pickletown starts with net income and then adjusts that amount for depreciation and other noncash items, and also accruals. This is an example of which of the following?

    a. The direct method.

    b. The indirect method.

    c. The cash method.

    d. The accrual method.

12. When reporting cash flows from investing activities, which of the following can be reported net instead of gross?

    a. Cash receipts.

    b. Cash payments.

    c. Long-term investments.

    d. Credit card receivables.

13. Which of the following should be included in the summary of significant accounting policies?

    a. Policies for which there is one acceptable alternative.

    b. Peculiarities based on the entity's industry.

    c. GAAP applications that are typical and reasonable.

    d. All accounting policies used, regardless of materiality.

14. Which of the following entities has correctly addressed an issue related to the financial statement notes?

    a. Northern Boundaries considers its notes supplemental information and does not include them in its financial statements.

    b. Southern Services has its accountant take responsibility for the notes since the accountant prepared them.

    c. Western Wear presents its financial statement notes separately after its basic financial statements.

    d. Eastern Eateries copies disclosures into its notes for reference that were presented on the face of the financial statements.

15. Which of the following is correct regarding the presentation of supplementary information in financial statements?

    a. All applicable financial framework information can be included in the supplemental schedule.

    b. Forecasts and projections will be considered supplementary information.

    c. The entity, not the accountant, must decide what supplementary information to include.

    d. The supplementary information will typically be presented separately from the basic statements.

16. According to FASB ASC 275-10-50-1, GAAP requires disclosure about which of the following risks and uncertainties?

    a. Risks and uncertainties related to the nature of the entity's operations.

    b. Risks and uncertainties related to deficiencies in the entity's internal control.

    c. Risks and uncertainties related to potential changes in regulations.

    d. Disclosure of all risks and uncertainties is required by GAAP.

17. When deciding whether it needs to use a certain significant estimate, Whammy Inc. determines that the possible future event upon which the estimate is contingent is more than remote but less than likely. Based on the terminology in FASB ASC 450, this would be called which of the following?

    a. Probable.

    b. Reasonably possible.

    c. Unlikely.

    d. Remote.

18. A financial instrument with at least one underlying, at least one notional amount or payment provision, no (or very low) initial net investment, and that allows net settlement is called what?

    a. An uncertainty.

    b. A derivative.

    c. A variable interest entity.

    d. A single financial instrument.

19. How should a small to midsized nonpublic company present and disclose issues related to its receivables?

    a. Only recognize losses that have already occurred, omitting reasonably possible and probable losses.

    b. Separate individual receivables with special characteristics from all other receivables evaluated together.

    c. Presume that all receivables due to the company will be realized.

    d. Omit disclosures about receivables because GAAP does not require them.

20. Which of the following is required of any company that wants to change its fiscal year?

    a. A disclosure in the year after the change.

    b. A long-year (more than 12 months) tax return.

    c. Approval from their audit firm.

    d. Permission from the IRS Commissioner.

21. Per FASB ASC 740-10, what chance must an uncertain tax position have of being accepted by the IRS to be used in an entity's financial statements?

    a. Greater than 25%.

    b. Greater than 50%.

    c. Greater than 75%.

    d. Greater than 90%.

22. FASB ASC 810-10 provides small and midsize nonpublic entities an accounting alternative that relates to which of the following?

    a. An option to exempt the entity from considering if it has any variable interest entity (VIE) relationships.

    b. An option to exempt the entity from having to make disclosures about its VIE relationships.

    c. An option to exempt certain defined related party leasing arrangements from the scope of the VIE Subsections.

    d. An option to exempt the entity from having to consolidate the financial results of a governmental organization.

23. Which of the following relationships indicates that a reporting entity has an interest in a variable interest entity (VIE)?

    a. The reporting entity helped to design the entity.

    b. 25% of the entity's activities are conducted on behalf of the reporting entity.

    c. The entity provides all of its own financial support.

    d. The entity's primary activities are related to earning a profit.

24. Consolidating financial statements would include columns for what information?

    a. Consolidated totals for both parent entities and subsidiaries.

    b. Parent company financial statements and subsidiary financial statements.

    c. Parent company financial statements, subsidiary financial statements, and consolidating entries.

    d. Parent company financial statements, subsidiary financial statements, consolidating entries, and balances for consolidated totals.

25. When would an accountant's report cover only consolidated information but not consolidating information?

    a. The consolidating information is included as supplemental information.

    b. The consolidating information is included on the face of the financial statements.

    c. Due to soft wording in GAAP, it is up to the professional judgment of the accountant.

    d. It depends on the unique facts and circumstances of each set of financial statements.

26. The price that an entity would receive if it sold an asset in an orderly transaction between appropriate market participants at a specific measurement date is called what?

    a. A controlling financial interest.

    b. The fair value.

    c. A materiality judgment.

    d. A variable interest.

27. An entity that uses bid and ask prices to measure fair value should use which price to value the asset?

    a. A price above the most recent ask.

    b. A price below the most recent bid.

    c. A representative price within the bid-ask spread.

    d. It depends where the asset falls within the fair value hierarchy.

28. Based on applicable professional guidance, in what types of SSARS engagements must an accountant consider materiality?

    a. In reviews, but not in compilations or financial statement preparations.

    b. In compilations, but not in reviews or financial statement preparations.

    c. In compilations and reviews, but not in financial statement preparations.

    d. In financial statement preparations, compilations, and reviews.

29. Which of the following statements best describes an aspect of partnership taxation?

    a. Partnership income is taxed to the partners, so federal income tax expenses are omitted from the partnership financial statements.

    b. A state-levied tax should be shown as an expense on the personal financial statements of each partner, not the partnership as a whole.

    c. The uncertainty and disclosure principles of FASB ASC 740-10 must be taken into account when preparing a partnership's tax return.

    d. Partnership financial statements are still presented in accordance with GAAP if they require income taxes be computed at a specific rate and included as an expense.

30. The Amicable Partnership makes guaranteed payments to a partner, though he does little actual work for the partnership. How would they be accounted for?

    a. As an allocation of partnership income.

    b. As a partnership expense.

    c. As a loan.

    d. As a change in partnership interest.

31. Which of the following would be labeled "Partners' Capital" in partnership financial statements?

    a. Loans made from the partnership to partners.

    b. The statement of changes in partners' capital.

    c. The equity section of the partnership's balance sheet.

    d. Payments into a partnership retirement plan on behalf of partners.

32. Does the change to a partnership from a different type of business entity need to be made retrospectively?

    a. Yes, retrospective change is needed because this is a change in accounting principle.

    b. Yes, retrospective change is required by FASB ASC 250-10.

    c. No, retrospective change is inappropriate unless needed to enhance comparability.

    d. No, retrospective change is prohibited by FASB ASC 250-10.

33. What is a disadvantage of operating as a limited liability company (LLC)?

    a. Only a specific number of members can be included.

    b. Tax laws can be different in each state.

    c. Members are exposed to double taxation—at both entity and personal levels.

    d. Only individuals can serve as members of LLCs.

34. What is the biggest advantage of operating as a limited liability partnership (LLP)?

    a. LLPs have favorable rules for pass-through taxation.

    b. LLPs are available in all states, while LLCs are not.

    c. LLPs provide members with more liability protection than LLCs.

    d. LLPs provide members less liability protection than a general partnership.

35. Where might an S corporation disclose changes in the components of its retained earnings?

    a. The balance sheet.

    b. The statement of retained earnings.

    c. The statement of income.

    d. The statement of cash flows.

36. Per FASB ASC 740-10, if an S corporation pays income taxes attributable to its owners, how are they accounted for?

    a. As a parenthetical disclosure in the accountant's report.

    b. As a disclosure in the notes to the financial statements.

    c. As a transaction with the owners.

    d. As a stockholder distribution on the owners' financial statements.

37. Why is it a good accounting practice for S corporations to maintain separate retained earning accounts in their books?

    a. Each account is required to have a separate caption and amount on the balance sheet.

    b. Separate accounts are usually needed to ensure proper tax accounting.

    c. The primary users of S corporation financial statements are third parties.

    d. Because they are included in new accumulated earnings and profits.

38. S corporation losses passed through to shareholders are deductible to what extent?

    a. Their adjusted bases in the stock plus accumulated earnings and profits (AEP).

    b. Their share of AEP and other retained earnings (ORE).

    c. Their adjusted bases in the stock plus carryover amounts from previous years.

    d. Their adjusted bases in the stock plus debt due to them from the corporation.

39. Do S corporations need to record originating and reversing tax/book temporary differences?

    a. No, because they do not pay federal income tax.

    b. Yes, unless they report using a special purpose framework.

    c. Yes, because retained earnings accounts might be affected.

    d. Yes, because they have to pay that amount in federal income taxes.

40. Upon termination of S corporation election, what is the effect on the retained earnings account?

    a. Certain retained earnings items should be merged with other retained earnings (ORE).

    b. All retained earnings must be distributed to the shareholders tax free.

    c. Distributions from the accumulated adjustment account (AAA) are prohibited.

    d. Future earnings of the entity will be frozen permanently.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Compilation and Review Engagements—Course 1—Form and Presentation of Financial Statements, Partnerships, and S Corporations (CARTG211)

Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State/ZIP: _____

Firm Phone: _____ Firm Fax No.: _____

Firm Email: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answers for each question by filling in the appropriate circle as shown: Fill in like this: ● not like this: Ⓘ ⊗ ✓

You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

You may complete the exam online for $109 by logging onto our Online Grading Center at **cl.tr.com/ogs.** Alternatively, you may fax the completed Examination for CPE Credit Answer Sheet and Self-study Course Evaluation to Thomson Reuters (Tax & Accounting) Inc. at (888) 286-9070 or email it to *CPLGrading@thomsonreuters.com.* Mailing instructions are included in the Exam Instructions. Payment information must be included for all print grading. The price for emailed or faxed answer sheets is $109; the price for answer sheets sent by regular mail is $119.

Expiration Date: July 31, 2022

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Compilation and Review Engagements—Course 1—Form and Presentation of Financial Statements, Partnerships, and S Corporations (CARTG211)

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. How would you rate the appropriateness of the course materials for your experience level?	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course content?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant, and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. _____

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can. (Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of this page. **Yes/No** ○ ○

For more information on our CPE & Training solutions, visit cl.tr.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____.

GLOSSARY

Account form: A side-by-side balance sheet presentation. Assets are presented on the left-hand side of the statement and liabilities and stockholders' equity on the right-hand side. It may be presented on two facing pages.

Accumulated adjustments account (AAA): An amount defined by federal tax regulations that reflects the aggregate amount of undistributed income and gains that have been taxed to the shareholders after 1982.

Accumulated earnings and profits (AEP): An amount defined by federal tax regulations that applies to S corporations with previous Subchapter C status. It generally does not apply to corporations that immediately elect S corporation status. AEP generally represents retained earnings that exist when S corporation status is attained, with certain adjustments required by the federal tax regulations.

Basic financial statements: The basic financial statements typically included in a GAAP financial statement presentation are the (1) balance sheet, (2) statement of income, (3) statement of comprehensive income, (4) statement of retained earnings or changes in stockholders' equity, and (5) statement of cash flows.

Cash: This includes more than currency on hand. It also includes demand deposits with banks or other financial institutions, as well as other kinds of accounts that have the general characteristics of demand deposits (i.e., the customer may deposit additional funds at any time and withdraw funds at any time without prior notice or penalty, such as money market accounts).

Cash equivalents: Short-term, highly liquid investments that (1) are readily convertible to known amounts of cash and (2) are near enough to maturity that any risk of changes in value due to changes in interest rates is insignificant (e.g., Treasury bills).

Combined financial statements: These are used when commonly controlled companies are likely to be more meaningful than their separate financial statements. Because none of the companies involved in these statements has an investment in the common stock of the other companies (like in consolidated/consolidating statements), the equity accounts of the various companies are combined rather than offset against the investment in subsidiaries held by the parent company.

Comprehensive income: This includes both net income and other comprehensive income (i.e., certain revenues, expenses, gains, and losses that are reported as separate components of stockholders' equity rather than net income).

Consolidated financial statements: Statements that combine a parent company's financial position and results of operations with those of its subsidiaries as if they were a single entity.

Consolidating financial statements: Statements that present the financial position and results of operations of the parent company and each of its subsidiaries in columnar form, together with columns that show eliminations of intercompany items and the consolidated totals.

Derivative: A financial instrument or other contract with all of the following characteristics: (1) at least one underlying and one notional amount or payment provisions or both; (2) requires no initial net investment or an initial net investment lower than that required for other types of contracts expected to respond similarly to changes in market factors; and (3) terms that require or allow net settlement, can be readily settled net by a method outside the contract, or provides for delivery of an asset that puts the recipient in a position similar to net settlement.

Direct method: A method for presenting cash flow from operations that begins with cash receipts and deducts cash payments for operating costs and expenses, individually listing the cash effects of each major type of revenue and expense. The following categories of operating cash receipts and payments are required: (1) cash collected from customers, including lessees and licensees; (2) interest and dividends received; (3) other operating cash receipts, if any; (4) cash paid to employees and other suppliers of goods and services, including suppliers of insurance and advertising; (5) interest paid; (6) income taxes paid; and (7) other operating cash payments, if any.

Fair value: The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Financial instrument: Cash; evidence of ownership of an entity; or a contract that both (1) imposes on one entity a contractual obligation either (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity and (2) conveys to that second entity a contractual right either (a) to receive cash or another financial instrument from the first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity.

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

Indirect method: A method for presenting cash flow from operations that starts with net income and adjusts for (1) noncash items, such as depreciation and deferred income taxes, and (2) accruals.

Investing activities: Lending money, collecting on loans, acquiring and selling or disposing of securities, and acquiring and selling or disposing of productive assets that are expected to generate revenue over a long period of time.

Limited liability companies (LLCs): Business entities created under state law that are owned by members and combine many of the tax advantages of a partnership with the liability protection of a corporation. Each state establishes its own rules and characteristics for LLCs.

Limited liability partnerships (LLPs): These are a special type of general partnership that exists under state laws. Partners in an LLP are personally liable for the commercial or other obligations of the entity, their own acts and omissions, and the acts and omissions of people under their supervision. However, within this structure, LLP partners are not liable for acts and omissions by the other LLP partners or nonsupervised employees.

Near term: A period of time that does not exceed one years from the date of the financial statements.

Other retained earnings (ORE): Any amount that would be viewed as retained earnings under GAAP and state corporation law that is included in shareholders' bases for tax purposes, but is not included in the specific definitions of AAA, AEP, or TTA.

Partnership: An arrangement where two or more individuals share the liabilities and profits of a business venture. Different arrangements are possible, including limited partners and general partners. Such arrangements are usually governed by a partnership agreement.

Probable: A future event (or events) is likely to occur.

Reasonable possible: The chance of a future event (or events) occurring is more than remote, but less than likely.

Remote: There is only a slight chance of a future event (or events) occurring.

Running format: A running format presentation used for balance sheets in which assets appear at the top of the page and liabilities and stockholders' equity appear at the bottom. Generally, this presentation will appear on one page.

S corporation: A business entity that is similar to a C corporation, except that it provides liability protection and pass-through taxation to its members.

Severe impact: This is a significant financially disruptive effect on an entity's normal functioning. It is a higher threshold than material, but does include matters that are less than catastrophic.

Special purpose framework: Frameworks other than GAAP used to prepare financial statements, including the cash basis, the tax basis, the regulatory basis, the contractual basis, and other bases [i.e., other comprehensive bases of accounting (OCBOA)].

Substantive kick-out rights: The right for a limited partner to dissolve a limited partnership.

Summary of significant accounting policies: This is required by GAAP when financial statements that purport to present financial position (balance sheet), results of operations (statement of income), or cash flows (statement of cash flows) are issued. It identifies and describes the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, results of operations, or cash flows. This disclosure should encompass important judgments about the appropriateness of principles related to recognition of revenue and allocation of assets to future periods. It should describe accounting principles and methods that involve (1) a selection from existing acceptable alternatives, (2) industry peculiarities, and (3) unusual or innovative applications of GAAP.

Supplementary information: This is information that is not part of the basic financial statements and is not required for fair presentation in accordance with GAAP, though it is often useful to owners, management, or creditors (e.g., detailed schedules, summaries, comparisons, or statistical information).

Tax temporary adjustments (TTA): A term developed for this course to represent retained earnings changes that result when tax/book differences originate and then reverse. Such differences are not recognized for tax purposes in the AAA and AEP calculations. TTA are not viewed as part of shareholders' tax bases in their shares.

Variable interest: In a variable interest entity, this is a contractual, ownership, or other pecuniary interest in the entity that changes with fluctuations in the fair value of the entity's net assets.

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COMPANION TO PPC'S GUIDE TO COMPILATION AND REVIEW ENGAGEMENTS

COURSE 2

REVIEW PROCEDURES AND REPORTING ON COMPILED OR REVIEWED FINANCIAL STATEMENTS (CARTG212)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses issues related to compilation and review engagements. Lesson 1 discusses the review procedures needed to obtain the limited assurance required for a review engagement. Lesson 2 discusses concerns that may arise when reporting on compiled or reviewed financial statements.
PUBLICATION/ REVISION DATE:	July 2021
RECOMMENDED FOR:	Users of *PPC's Guide to Compilation and Review Engagements*
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 **July 31, 2022**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Review Procedures

Completion of this lesson will enable you to:

- Recognize how accountants gain knowledge of clients, industries, and financial reporting frameworks; design review procedures, inquiries, and analytical procedures.
- Identify other issues affecting procedures such as going concern, representation letters, and initial reviews.

Lesson 2—Reporting on Compiled or Reviewed Financial Statements

Completion of this lesson will enable you to:

- Identify reporting obligations for compiled and reviewed statements, requirements for reporting, levels of service, and dating reports.
- Determine methods for dealing with a lack of independence; financial statements that omit substantially all disclosures, the statement of cash flows or comprehensive income; GAAP departures; scope limitations; single financial statements; supplementary information; and charts and graphs.
- Recognize requirements for reporting on comparative financial statements, accounting changes, nonprofit organizations, and governmental entities.
- Identify other reporting situations that may occur with compiled or reviewed financial statements.

TO COMPLETE THIS LEARNING PROCESS:

Log onto our Online Grading Center at **cl.tr.com/ogs**. Online grading allows you to get instant CPE credit for your exam.

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

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See the test instructions included with the course materials for additional instructions and payment information.

ADMINISTRATIVE POLICIES

For information regarding refunds and complaint resolutions, dial (800) 431-9025 (Option 2) for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Review Procedures

INTRODUCTION

This lesson discusses the procedures an accountant may perform during a review engagement. The topics covered include inquiries, analytical procedures, going concern considerations, representation letters, and more.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize how accountants gain knowledge of clients, industries, and financial reporting frameworks; design review procedures, inquiries, and analytical procedures.
- Identify other issues affecting procedures such as going concern, representation letters, and initial reviews.

Review Engagements

The objective, when performing a SSARS review, is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with a particular financial reporting framework. This limited assurance is obtained primarily through the performance of inquiry and analytical procedures, and is the basis for reporting.

AR-C 90 (AR-C 90A) contains the performance requirements for a review. The accountant engaged to review financial statements should—

a. Establish an understanding with the entity regarding the services to be performed and document the understanding through a written communication with management or those charged with governance [AR-C 90.16 (AR-C 90A.11)]. SSARS No. 25 (AR-C 90.16) includes an explicit requirement to agree on the terms of the engagement prior to the commencement of the engagement.

b. Communicate with management or those charged with governance regarding significant matters that arise during the review engagement [AR-C 90.18 (AR-C 90A.13)].

c. Determine materiality (AR-C 90.19–.20).

d. Have, or obtain, a level of knowledge of the accounting principles and practices of the industry in which the entity operates and a general understanding of certain matters related to the entity itself [AR-C 90.21–.23 (AR-C 90A.14–.16)].

e. Design and perform review procedures with professional skepticism, based on the accountant's—[AR-C 90.11 and AR-C 90.24–.25 (AR-C 90A.17–.18)]

    - understanding of the industry,
    - knowledge of the client, and
    - awareness of the risk of unknowingly failing to modify the review report on financial statements that are materially misstated.

f. Perform appropriate inquiry, analytical, and other procedures [AR-C 90.26–.30 (AR-C 90A.19–.23)].

g. Read the financial statements and consider whether they conform with the applicable financial reporting framework based on the information the accountant acquires while performing the review [AR-C 90.31 (AR-C 90A.24)].

h. Perform additional procedures to address specific circumstances such as related parties and related party transactions., fraud and noncompliance with laws and regulations, and going concern. [AR-C 90.32–.38 (AR-C 90A.51 and AR-C 90A.65–.66)].

i. Obtain and read reports from other accountants who issued a report on the financial statements of significant components [AR-C 90.40 (AR-C 90A.25)].

j. Determine that the financial statements reviewed reconcile to the underlying accounting records [AR-C 90.41 (AR-C 90A.26)].

k. Accumulate and evaluate misstatements in the financial statements, request that management consider any unsatisfactory information obtained while performing the review procedures, perform any additional procedures necessary to obtain limited assurance that the financial statements are in accordance with the applicable financial reporting framework, and evaluate whether there is sufficient and appropriate review evidence [AR-C 90.45–.47 (AR-C 90A.27–.31)].

l. Form a conclusion. Reporting is discussed in Lesson 2.

m. Prepare appropriate documentation [AR-C 90.137–.139 (AR-C 90A.94–.95)].

n. Request representations from management for all financial statements and periods covered by the accountant's review report [AR-C 90.58–.63 (AR-C 90A.32–.37)].

These performance requirements clearly state that the accountant is expected to perform inquiry, analytical, and other procedures before expressing limited assurance. Thus, merely preparing financial statements and reading them is an insufficient basis for expressing limited assurance. On the other hand, as stated in AR-C 90.A4 (AR-C 90A.A4), a review does not contemplate obtaining an understanding of internal control, assessing fraud risk, testing accounting records by obtaining corroborating evidential matter, and certain other procedures ordinarily performed during an audit. Thus, the procedures required for a review of financial statements fall somewhere between the two extremes of SSARS financial statement preparation standards and GAAS.

SSARS No. 25, *Materiality in a Review of Financial Statements and Adverse Conclusions*

In February 2020, the AICPA Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 25, *Materiality in a Review of Financial Statements and Adverse Conclusions*. These amendments to the SSARS are a result of ARSC's project to converge AR-C 90, *Review of Financial Statements*, with International Standard on Review Engagements (ISRE) 2400, *Engagements to Review Historical Financial Statements (Revised)* and remove inconsistencies between the SSARS and the auditing standards with respect to concepts that should apply to all service levels. In general, SSARS No. 25 provides for the following: makes explicit the requirement that the accountant should determine materiality for the financial statements as a whole and apply this benchmark when designing procedures and evaluating results; provides for an adverse conclusion in a review report when there is evidence of pervasive and material misstatement of the financial statements; and revises the accountant's review report to state that the accountant is required to be independent with respect to the entity and also to comply with ethical responsibilities under the relevant professional standards. In addition, SSARS No. 25 provides language clarifying existing requirements and expands application guidance. SSARS No. 25 is effective for engagements performed in accordance with SSARS for periods ending on or after December 15, 2021, with early implementation permitted, and is codified at AR-C 60, AR-C 70, AR-C 80, and AR-C 90. Pre-SSARS No. 25 standards are recodified at AR-C 60A, AR-C 70A, AR-C 80A, and AR-C 90A. SSARS No. 25 is available on the AICPA website at **www.aicpa.org/content/dam/aicpa/interestareas/frc/reviewcompilationpreparation/downloadabledocuments/ssars25/ssars-25.pdf** and on Checkpoint at **https://checkpoint.riag.com/**. This course fully implements SSARS No. 25 by providing dual guidance, as appropriate.

OBTAINING KNOWLEDGE OF THE CLIENT, INDUSTRY, AND FINANCIAL REPORTING FRAMEWORK

The SSARS require that an accountant who reviews financial statements have, or obtain, knowledge of the applicable financial reporting framework and significant accounting policies to be used by the client in the preparation of the financial statements. To obtain this understanding, the accountant needs an understanding of the client's

business and its financial reporting framework. The understanding of the client's business should include a general understanding of:

- the client's organization;
- its operating characteristics; and
- the nature of its assets, liabilities, revenues, and expenses;

and is generally obtained through experience with the client or its industry and inquiry of the client's personnel. The understanding of the accounting principles and practices used by the client should include the accounting principles and practices used in measuring, recognizing, recording, and disclosing all significant accounts and disclosures in the financial statements. The accountant should be alert to changes in accounting practices and principles and differences from industry norms.

What Level of Knowledge Is Necessary?

The accountant need not be an expert in the industry nor even have experience in the industry. He or she must, however, be familiar with its unique principles and practices. Unless the accountant is at least aware of the accounting principles and practices of the industry, he or she will not have an adequate basis for the selection of his or her inquiries and analytical procedures, nor will he or she have a sound basis for making professional judgments concerning the results of the review procedures.

Each business within an industry is unique to some degree. Thus, the accountant must go beyond his or her knowledge of the industry and acquire an understanding of the entity's business. The level of understanding concerns the scope of the accountant's knowledge rather than its depth. An in-depth knowledge of the industry but a lack of familiarity with the entity's business (or vice versa) is not an adequate basis for performing a review service.

How to Acquire It

Generally, an accountant acquires an understanding of the industry through experience with the entity being reviewed or other entities in the same industry. However, experience is not a prerequisite for performing a review. In the absence of experience, the accountant must acquire his or her knowledge of the industry through study or consultation. AICPA guides, industry publications, financial statements of other entities in the industry, textbooks, periodicals, and individuals knowledgeable about the industry are all potential references. The entity's website also may provide an extensive amount of information. For example, some companies present information about company history, products or services, locations, partnerships, and key employees.

Likewise, previous experience is an excellent way to obtain an understanding of the entity's business. Inquiries of personnel, observation of operations, and review of previous financial statements are also methods of becoming familiar with the entity's business..

THE DESIGN AND PERFORMANCE OF REVIEW PROCEDURES

AR-C 90.24 and AR-C 90.A45 (AR-C 90A.17 and AR-C 90A.A34) state that the accountant should perform procedures designed to accumulate sufficient appropriate review evidence that will provide a reasonable basis for obtaining limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. This review evidence is primarily obtained through analytical procedures and inquiries.

The use of analytical procedures in a review is different than the use of analytical procedures in an audit. In an audit, analytical procedures are used both in planning the audit and as part of the final or overall review stage of the audit. In addition, they are frequently used, but not required to be used, as substantive procedures. In a review, the accountant is not required to perform analytical procedures when designing the review procedures (i.e., planning the engagement) or as a final review procedure. Accountants are required to use analytics when performing the review procedures as part of gathering review evidence.

The analytical procedures, inquiries, and other procedures performed should be designed based on the accountant's understanding of the industry, knowledge of the client, and awareness of the *risk* that the financial statements may be materially misstated. For example, if the CFO of the client was previously a manager with a respected accounting firm and has been the CFO of the client for several years; the accountant has not found any adjustments that need to be made to the financial statements in prior years; and there have been no significant changes to the business, then the risk of material misstatement is likely minimal. However, the risk would be much greater if this were a first year review client.

The accountant should focus the analytical procedures and inquiries in those areas where the accountant believes there are increased risks of misstatements. (For example, if the client has terminated some of its franchise agreements, the accountant may need to tailor review procedures to assess whether to report discontinued operations and to consider impairment, going concern implications, and costs to exit activities. Another area that might merit increased focus is account balances that are subject to management estimate.) This concept of *risk awareness* is not the same in a review engagement as it is in an audit engagement. In an audit engagement, the auditor is required to perform procedures to assess risks. In a review engagement, an assessment is not required. In addition, in an audit, the work performed by the auditor is to obtain a *reasonable* or *high level* of assurance. In a review, the work performed by the accountant is to obtain a *limited* level of assurance. Consequently, sufficient review evidence is obtained primarily though analytical procedures and inquiries. However, based on professional judgment, the accountant may decide to perform procedures ordinarily performed in an audit. Doing so does not require the accountant to perform an audit of the financial statements. The engagement remains a review.

SSARS No. 25 adds the requirement for the accountant to design and perform analytical procedures and inquiries to address all material items in the financial statements, including disclosures.

PPC's *SMART Practice Aids—Compilation and Review* brings enhanced functionality to existing Practice Aid products by automating specific processes and generating completed practice aids. *Checkpoint Engage* PCR (Preparation, Compilation, and Review) is a fully integrated online engagement solution that provides increased engagement efficiency and quality.

MAKING INQUIRIES

The following paragraphs discuss the inquiries the accountant is required to make of members of management and others, and present the inquiries required both before and after implementing SSARS No. 25.

Inquiries Before Implementing SSARS No. 25

AR-C 90A.22 requires the accountant to inquire of members of management who have responsibility for financial and accounting matters concerning the financial statements about:

a. Whether the financial statements have been prepared and fairly presented in accordance with the applicable financial reporting framework (i.e., GAAP or a special purpose framework).

b. Unusual or complex situations that may have an effect on the financial statements.

c. Significant transactions occurring or recognized near the end of the reporting period.

d. The status of uncorrected misstatements identified during the prior engagement.

e. Matters about which questions have arisen in the course of applying the review procedures.

f. Events subsequent to the date of the financial statements that could have a material effect on the financial statements.

g. Knowledge of any fraud or suspected fraud affecting the entity involving management, employees, or others where the fraud could have a material effect on the financial statements.

h. Knowledge of allegations of fraud or suspected fraud affecting the entity communicated by employees, former employees, or others.

i. Whether management has disclosed to the accountant all known or suspected instances of noncompliance with laws and regulations whose effects should be considered when preparing the financial statements.

j. Significant journal entries and other adjustments.

k. Communications from regulatory agencies.

l. Related parties and significant related party transactions.

m. Any litigation, claims, assessments, or other uncertainties that existed at the financial statement date or during the period from the financial statement date to the date of inquiry.

n. Whether management believes that significant assumptions used in making estimates are reasonable.

o. Actions taken at meetings of the governing board, committees of the governing board, or comparable meetings.

Additional inquiries may be made. The accountant has a great deal of flexibility in determining the extent of the additional inquiries to be made in a particular review engagement. Obviously, additional questions may arise during the course of applying review procedures, and these additional matters should be added to the original list of inquiries.

Inquiries After Implementing SSARS No. 25

AR-C 90.29 requires the accountant to inquire of members of management who have responsibility for financial and accounting matters or other appropriate individuals concerning the financial statements about:

a. Whether the financial statements have been prepared and fairly presented in accordance with the applicable financial reporting framework (i.e., GAAP or a special purpose framework), including how management determined the reasonability of accounting estimates.

b. Identification of related parties and significant related party relationships or transactions and their purpose.

c. Significant, unusual or complex transactions, events, or matters that may have an effect on the financial statements, including—.

(1) Significant financial statement adjustments or journal entries.

(2) Significant changes in the entity's operations.

(3) Effects on the entity of related party transactions and relationships.

(4) Significant changes in contract terms that materially affect the entity's financial statements.

(5) Significant transactions occurring or recognized during the period, especially those occurring at the end of the reporting period.

(6) The status of uncorrected misstatements identified in the prior period review.

d. Matters about which questions have arisen in the course of applying the review procedures.

e. Actual, suspected, or alleged fraud or noncompliance with laws and regulations or noncompliance with laws and regulations that directly affect material financial statement amounts and disclosures.

f. Identification and consideration of events subsequent to the date of the financial statements that would be required to be adjusted for or disclosed in the financial statements.

g. The basis for management's assessment of the entity's ability to continue as a going concern and whether there are any events or conditions that cast doubt on that assessment.

h. Material commitments, contractual obligations, or contingencies that have affected or may affect the entity's financial statements, including disclosures.

i. Material nonmonetary transactions or transactions for no consideration in the financial reporting period under consideration.

j. Communications from regulatory agencies.

k. Any litigation, claims, assessments, or other uncertainties that existed at the financial statement date or during the period from the financial statement date to the date of inquiry.

l. Actions taken at meetings of the governing board, committees of the governing board, or comparable meetings.

Additional inquiries may be made. The accountant has a great deal of flexibility in determining the extent of the additional inquiries to be made in a particular review engagement. Obviously, additional questions may arise during the course of applying review procedures, and these additional matters should be added to the original list of inquiries.

The accountant should consider the reasonableness of management's responses based on the results of other review procedures and the accountant's knowledge of the entity's business. But, the accountant is not required to corroborate management's responses.

THE USE OF ANALYTICAL PROCEDURES

Purpose of Analytical Procedures

Analytical procedures are required in a review engagement. They should assist the accountant in identifying relationships and individual items that appear unusual. Often the analytical procedures can identify problem areas in the financial statements that are not always evident when the financial statements are merely read by the accountant. The results of analytical procedures should be used as a basis for making additional inquiries when appropriate. Together with the accountant's knowledge of the industry, understanding of the entity's business, and inquiries, the analytical procedures provide the review evidence that is the basis for the limited assurance given in the accountant's review report.

What Are Analytical Procedures?

AR-C 90.26–.27 (AR-C 90A.19–.20) states that analytical procedures *should* include—

- Comparing financial statements with comparative information for the prior period.
- Considering plausible relationships among both financial and relevant nonfinancial information.
- Comparing recorded amounts, or ratios developed from recorded amounts, to expectations.
- Comparing disaggregated revenue data (for example, comparing the data by period, by product line or operating segment, or by location), as applicable.

When designing and performing analytical procedures, the accountant *should*—

- Determine the suitability of the analytical procedures being performed.
- Consider the reliability of the data used to develop the expectation.
- Develop an expectation of recorded amounts or ratios that is precise enough to provide the accountant with limited assurance that a misstatement will be identified.
- Determine the amount of any difference between recorded amounts and expectations that will not require further investigation.

There are three basic types of analytical procedures:

a. Trend analysis involves the study of the change in accounts over time. For example, when comparative financial statements are presented, accountants often compare current year amounts with those of the prior year. That is the simplest form of trend analysis. Comparisons of amounts for several successive years, however, are generally more reliable and useful.

b. Reasonableness tests are those that estimate a financial statement amount or the change in an amount from the prior year. Generally, reasonableness tests use operating or other nonfinancial data, e.g., estimating investment income by considering the amount invested and the average interest rate, or estimating payroll expense by considering the number of employees and average wage rates. However, reasonableness tests sometimes use only financial information, e.g., estimating depreciation expense by considering the average investment in property and equipment and the depreciation methods used.

c. Ratio analysis involves the study of the relationship between two financial statement amounts. Ratios generally assess an aspect of (1) operations, e.g., a ratio of net income to sales, (2) financial position, e.g., a ratio of current assets to current liabilities, or (3) operations as related to financial position, e.g., a ratio of net income to total assets.

Selecting Appropriate Analytical Procedures

The accountant should apply analytical procedures to the financial statements to identify and provide a basis for inquiry about the relationships and individual items that appear to be unusual and that may indicate a material misstatement. As stated in AR-C 90.A54 (AR-C 90A.A42), these analytical procedures may be performed at the financial statement level or at the detailed account level. In addition, the nature, timing, and extent of the procedures performed should be determined based on the accountant's professional judgment. The risk of misstatement should be considered when applying professional judgment to determine the nature, timing, and extent of the procedures to be performed. As an example, when considering the timing of the procedures, the accountant may only want to look at rent expense on an annual basis if the lease agreement has a fixed rate for the year. However, if the client's revenues are generated from ticket sales and the client has large seasonal variations in attendance, the accountant may want to look at ticket revenue on a monthly basis. When considering the level of detail, the accountant would want to be more precise in the performance of his or her procedures for the riskier accounts. For example, the entire balance in the petty cash account is probably not material. Consequently, a comparison of the current year balance to the prior year balance would be sufficient. However, accountants may want to perform a more detailed analytic on the accounts receivable allowance account.

The key to effective use of analytical procedures is identifying the existence or absence of an expected relationship or the presence of an unexpected relationship, e.g., there should be a predictable relationship among sales, accounts receivable, and bad debt expense based on the historical patterns of the business. Also, the accountant would expect a relationship to change in predictable ways in response to known changes in volume of production or sales, product mix, customer composition, and the local economy. A precise quantification of these relationships is not required. Instead, the accountant should focus on a few key relationships, or *drivers*, that provide an improved understanding of the financial statements and significant operating or financial changes. Management of a small business generally will already have identified the drivers they consider important in running the business. The accountant can learn about those key relationships or drivers during discussions held with management to obtain an understanding of the client, or based on prior experience with the client or the client's industry. In a small business engagement, the accountant normally has a sufficient understanding of the client and its operations to judgmentally identify the expected relationships.

Analytical procedures include comparing actual results with industry statistics or anticipated results. However, accountants who review the financial statements of nonpublic entities may not often make such comparisons either because relevant information needed for a particular analytical procedure is not available or not relevant to the client. Instead, practitioners generally use their experience with the client and their knowledge of the relationships that are significant in the client's industry to determine which relationships should be studied.

The following guidelines may be helpful in selecting appropriate analytical procedures:

a. To avoid applying unnecessary analytical procedures, determine the objective of the procedure being considered; i.e., is the procedure designed to provide information about existence or occurrence, completeness, rights or obligations, valuation or allocation, accuracy or classification, or cutoff? Then consider whether additional assurance about that assertion is needed to express limited assurance on the financial statements or whether sufficient assurance already has been obtained through inquiry and other analytical procedures.

b. If accounts required adjustments in prior years, inquiries (rather than analytical procedures) may be a more cost-effective way of determining whether adjustments also need to be made in the current year.

c. Income statement accounts are best analyzed by using ratios and reasonableness tests; trend analysis is typically less useful. (However, the authors find that trend analysis can be useful when analyzing income statement accounts over a 3- to 5-year period.) Ratio analysis is the most effective analytical procedure for studying balance sheet accounts.

d. Misstatements in an account can be distributed throughout the period or occur solely in one or a few months. Analytical procedures should be designed to detect at least part of any material error that has occurred. For example, comparing monthly sales over several years is generally more useful than comparing annual sales for the same period. Similarly, analytical procedures also tend to be more effective when applied on a divisional or product line basis.

e. It is generally more effective to estimate changes that should have occurred in the accounts being analyzed, based on the company and the circumstances, rather than to compare a current year amount with the prior year's to determine if it appears unreasonable.

Examples of Analytical Procedures

The types of analytical procedures applied will vary with the accountant's previous experience with the client, the client's industry, the nature and materiality of the accounts involved, and the nature of financial, operating, and other nonfinancial data available. [AR-C 90.A212 (AR-C 90A.A156) lists examples of types of analytical procedures that an accountant may consider performing in a review of financial statements.] Although checklists of procedures (such as those provided in *PPC's Guide to Compilation and Review Engagements*) can be very helpful, they cannot substitute for professional judgment. As conditions change from one client to another or one period to another, the accountant must challenge any standard checklist or list of prior-period procedures. However, the following paragraphs give some examples of analytical procedures that may be appropriate in certain circumstances.

Trend Analysis. Trend analysis compares either the absolute dollar amount or percentage change in accounts over time. When the accountant reads comparative financial statements and questions the fluctuations in accounts between years, he or she is applying the most basic analytical procedure. Other examples are comparison of monthly sales for the current period with those of prior periods, or analysis of a five-year sales trend. Although not widely used in practice, regression analysis is a statistical method of trend analysis. Many computer software programs are available for use in regression analysis.

Reasonableness Tests. A reasonableness, or predictive, test is a comparison of a recorded amount with an expectation developed based on financial or nonfinancial data. Some reasonableness tests involve ratios using financial information. For example, certain expense accounts are estimated by computing the following ratios:

a. Depreciation expense ÷ average depreciable property and equipment.

b. Repairs and maintenance ÷ property and equipment.

c. Interest expense ÷ interest-bearing debt.

d. Average depreciable property and equipment ÷ average depreciation period.

Other reasonableness tests involve estimating account balances by using operating or other nonfinancial data. For example:

a. Estimating revenue based on capacity, such as in a health care facility.

b. Estimating commissions based on sales volume.

c. Estimating investment income based on the amount invested and the average interest rate.

d. Estimating payroll expense based on the number of employees and average wage rates.

Ratio Analysis. Ratio analysis is the comparison of relationships between financial statement accounts, the comparison of an account with nonfinancial data (such as the comparison of sales per square foot of retail space), or the comparison of relationships between entities in an industry (such as comparison of gross profit with the industry average). Ratio analysis is most appropriate when the relationship between accounts is stable and fairly predictable. Some of the most common ratios evaluated are elements of net income as a percentage of revenue, e.g., gross profit or operating expenses. (In fact, such percentages are often presented on the face of the income statement, especially when computer-prepared financial statements are presented.) Some of the common ratios used for ratio analysis are as follows:

a. *Accounts Receivable Ratios.* These ratios help determine the collectibility and adequacy of accounts receivable, the allowance for doubtful accounts, and the provision for bad debts. Some of the more common accounts receivable ratios include:

   (1) *Allowance for Doubtful Accounts as a Percentage of Accounts Receivable*—used to review the reasonableness of the allowance account as compared to the ending accounts receivable balance.

   (2) *Bad Debt Expense as a Percentage of Net Credit Revenue*—used to determine the sufficiency of write-offs based on current year revenue.

   (3) *Accounts Receivable Turnover*—indicates the quality of the accounts receivable, and also provides an indication of how successfully the client is collecting its outstanding accounts receivable.

   (4) *Days Revenue in Accounts Receivable*—estimates the average collection period for credit revenue.

   (5) *Accounts Receivable by Aging Category to Total Accounts Receivable*—used in conjunction with the days revenue in accounts receivable ratio [see item (4)] to determine how the collection period changed. (The percentage breakdown among categories shows which aging category is responsible for the collection period change.)

b. *Inventory Ratios.* These ratios help assess the valuation of inventory. Some of the more common inventory ratios include:

   (1) *Inventory Turnover*—indicates how efficiently inventory was used. Represents the number of times inventory was sold in one year.

   (2) *Days of Inventory on Hand*—estimates the average duration of inventory during the year.

   (3) *Gross Profit Margin*—indicates how much of every net revenue dollar resulted in gross profit. More importantly, however, this ratio can serve as an indicator of unusual variances in cost of sales and inventory.

c. *Profitability, Leverage, and Liquidity Ratios.* These ratios generally do not provide information about specific assertions or accounts; rather, they help assess overall operating effectiveness, liquidity, and long-term solvency.

   (1) *Current Ratio*—indicates the amount of liquid assets available to liquidate current debt or the company's ability to meet its current obligations.

   (2) *Quick Ratio*—similar to the current ratio except that it omits items that cannot be quickly converted to cash. It indicates a more conservative estimate of liquidity.

(3) *Liabilities to Equity*—determines the extent of liabilities used to finance assets.

(4) *Debt to Equity*—determines the extent of nonequity capital used to finance assets.

(5) *Times Interest Earned*—used with the debt to equity ratio to focus on cash flow necessary to service long-term debt payments.

(6) *Return on Total Assets*—indicates how productively the company used its assets to produce profits. The ratio can be used to examine trends in efficiency.

(7) *Asset Turnover*—indicates how efficiently the company utilized its assets.

(8) *Return on Equity*—indicates the efficiency with which common shareholders' equity is employed by the firm.

(9) *Return on Net Sales*—indicates how much of every net sales dollar resulted in profit after taxes.

(10) *Operating Expenses as a Percentage of Net Revenue*—indicates how much of every net revenue dollar was used for operating expenses.

Ratios should not be computed just for the sake of computing them. Generally, practitioners should select only those ratios that provide information about assertions or accounts that are considered significant.

Developing an Analytical Ratio History. Many practitioners compute ratios and analyze trends using their own internal accounting software package (for example, using a spreadsheet software such as Excel). In such cases, the accountant selects the appropriate ratios for each engagement based on his or her knowledge of the client's business and industry, inquiries performed, and other analytical procedures performed and creates a computerized worksheet that will automatically compute the selected ratios. The authors caution practitioners to select only the ratios that provide information about assertions or accounts that are considered significant for a particular engagement (i.e., the key drivers discussed earlier in this section). Also, when using software packages to analyze trends, the practitioner should develop and document expectations for each ratio selected—even for those ratios that are expected to remain stable. Developing expectations is discussed below. A pre-made list of ratios, such as the ones provided in *PPC's Guide to Compilation and Review Engagements*, would not represent a complete list nor would each of the ratios necessarily be applicable to each review engagement. The accountant could, however, use such a worksheet for the current and past periods to create an analytical ratio history for that client. This history provides the accountant with a trend analysis that studies the change in various ratios over a period of time. The spreadsheet can then be carried forward and used for analysis in future periods. Comparisons of amounts for several successive years generally provides the accountant with more reliable and useful information.

Developing Expectations

AR-C 90.26 (AR-C 90A.19) requires the accountant to develop expectations. Forming an expectation is a critical phase of the analytical procedures process since the expectation represents the accountant's prediction of recorded amounts or ratios developed from recorded amounts. Once expectations are developed, the accountant will often find when performing analytical procedures that differences exist between the expectation and the recorded amount or ratio. If such differences are significant, they may be indicative of possible material misstatements, and the accountant should obtain explanations for such differences. The following paragraphs discuss developing expectations. The accountant's response when the results of analytical procedures are unfavorable is discussed later in this section.

Expectations are developed by identifying plausible relationships that are reasonably expected to exist based on the accountant's understanding of the client and the industry in which the client operates. The accountant selects from a variety of data sources to form expectations:

- Prior period information.
- Management's budgets or forecasts.
- Industry data.

- Non-financial data.
- Relationships of financial statement elements within the period.

When developing expectations, the accountant considers the following:

a. *Economic and Competitive Conditions.* The accountant should have an understanding of the industry in which the client operates, including significant trends.

b. *Changes in the Business.* Discussing changes in the business with the client prior to developing the expectations helps the accountant obtain a better understanding of the client's business so appropriate expectations can be developed. This discussion might take place as part of accountant's obtaining or updating his or her understanding of the client's business, or as part of other inquiries performed, as previously discussed.

c. *The Type of Account Involved.* The way an expectation is developed depends on the account. Expectations sometimes may be developed similarly for similar types of accounts. For example:

   - Expectations of fixed expenses might be based on prior-year balances.
   - Expectations of variable expenses might be based on relationships with other accounts.
   - Expectations for accounts affected by a variety of factors might be based on relationships between financial and nonfinancial information.

   Accountants can expect relationships between related financial statement amounts to cause the changes in those amounts to move in the same or opposite directions (i.e., a direct or inverse relationship, respectively). Unexpected increases or decreases may indicate that the information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory. The following accounts often exhibit a direct relationship (that is, if the primary account increases, the related accounts can also be expected to increase):

   Revenue and—

   Accounts Receivable

   Cost of Sales

   Selling Expenses

   Outbound Freight

   Commissions

   Inventory and—

   Accounts Payable

   Warehousing Costs

   Wages and Salaries Expense and—

   Payroll Taxes

   Health Insurance

   Interest Expense and—

   Long-term Debt

   Legal Expense (for collection of bad debts)

   Cash and Investments and—

   Investment Income (such as interest and dividends)

d. *The Number of Expectations Needed for an Account.* Ordinarily, there is no need to develop more than one expectation for an account. For example, if a sufficiently precise expectation can be developed based on the prior-year balance, there is no need to also compare the account balance with a forecasted amount. Also, if two or more expectations are equally effective, the accountant selects the one that is the most efficient to develop or use. For example, if the prior-year balance adjusted for known changes, the relationship with another account, and a forecast are equally effective expectations, but the forecasted balance is the easiest to use, that would be the expectation.

Documenting Expectations. AR-C 90.137 (AR-C 90A.94) does not specifically state what should be documented with respect to the analytical procedures performed. However, it does state that the working papers should be prepared in sufficient detail to provide a clear understanding of the nature, timing, and extent of the procedures performed; the results of the procedures performed; and significant findings or issues, conclusions reached, and judgments made in reaching those conclusions. Accountants will want to ensure that the review documentation supports that the analytical procedures required by AR-C 90.26 (AR-C 90A.19) have been performed.

AR-C 90.27c (AR-C 90A.20c) requires the accountant to develop an expectation of recorded amounts or ratios. Although not explicitly stated in the SSARS, the authors believe that an expectation should be developed for each analytic. However, there does not necessarily need to be a one to one correspondence between the expectations formed and the analytics performed, as one expectation may apply to multiple analytics. In addition, because the objective of a review is to provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the financial statements, the authors believe that expectations need only be developed in terms of a range (for example, revenue is expected to increase between 10% and 15%) and that analytics do not necessarily need to be developed for each financial statement item. The selection of which accounts to apply analytical procedures to is a matter of professional judgment based on materiality and the accountants' knowledge of the client and the industry in which the client operates. The accountant should apply analytical procedures to the financial statements to identify and provide a reasonable basis for inquiry about the relationships and individual items that appear to be unusual and that may indicate a material misstatement. The selection of appropriate analytical procedures was discussed in more detail earlier in this section. Exhibits 1-1 and 1-2 present examples of how the authors believe expectations in a review engagement could be documented. In each example, there is one expectation developed for each analytic, expectations are expressed in terms of a range, and the reason for each expectation is noted.

Exhibit 1-1

Documenting Expectations in a Review Engagement An Example

Background

An accountant is engaged to review the financial statements of Vista Building Suppliers, Inc., a company that provides building supplies to home builders.

Sample documentation
Vista Building Suppliers, Inc.
Analytical Procedures
For the year ended December 31, 20XX

Expectations:

The following are factors that should affect the relationship between current and prior year amounts:

- Because of lower interest rates, new home sales and new home building are up. Consequently, a 5% to 10% increase in revenue is expected. A similar increase is expected in cost of goods sold and days revenue in accounts receivable.
- Because of an increase in the production of prefabricated and custom items, the Company had to borrow additional funds. Therefore, an increase of between 10% and 15% is expected in loans payable and interest expense.

- No significant change in either days of inventory on hand or inventory turnover is expected. Any change greater than 5% will be subjected to additional inquiries.

Analytics:

	Current Year	Prior Year	Change	% Change
Revenue	$ 2,375,000	$ 2,175,000	$ 200,000	9.20%
Cost of goods sold	1,780,000	1,625,000	155,000	9.54%
Interest Expense	48,000	42,000	6,000	14.29%
Loans Payable	498,000	437,000	61,000	13.96%

Days revenue in accounts receivable = Accounts receivable (net)/ (Net credit revenue/360)

Current year days revenue in receivables = $1,600,000/ ($2,375,000/360)
= 243 days

Prior year days revenue in receivables = $1,250,000/ ($2,175,000/360)
= 207 days

The increase of 36 days revenue in accounts receivable (243 days – 207 days) represents a 17% increase. This increase is greater than the expected 5% to 10% increase. Discussions with Vista's management indicate that because new home starts are up, home builders have more need for cash flow up front and, consequently, have been slower to pay for their supplies. A comparison of last year's aged accounts receivables with this year's aged accounts receivables also indicates that home builders have been slower to pay.

Days of inventory on hand = Inventory at the end of the period/ (Total cost of goods sold/360)

Current year days of inventory on hand = $1,100,000/ ($1,780,000/360)
= 222 days

Prior year days of inventory on hand = $990,000/ ($1,625,000/360)
= 219 days

Inventory turnover = cost of sales/average inventory

Current year inventory turnover = $1,780,000/ (($1,100,000 + $990,000)/2)
= 1.7 times

Prior year inventory turnover = $1,625,000/ (($990,000 + $900,000)/2)
= 1.7 times

Exhibit 1-2 uses the information presented in Exhibit 1-1 to complete an "Analytical Procedures Documentation Form." This form is provided as a practice aid in *PPC's Guide to Compilation and Review Engagements*.

Exhibit 1-2

Documenting Expectations Using the Analytical Procedures Documentation Form

Company: *Vista Building Suppliers, Inc.* Financial Statement Date: *12/31/XX*

Completed by: *JRD* Date Completed: *3/11/XX*

Instructions: This optional form is designed to assist accountants in documenting the analytical procedures performed. Accountants should refer to the discussions in this section prior to completing this form.

Financial Statement Drivers

Sales, Debt, Inventory

General Expectations

- Because of lower interest rates, new home sales and new home building are up. Consequently, a 5% to 10% increase in revenue is expected. A similar increase is expected in cost of goods sold and days revenue in accounts receivable.
- Because of an increase in the production of prefabricated and custom items, the Company had to borrow additional funds. Therefore, an increase of between 10% and 15% is expected in loans payable and interest expense.
- No significant change in either days of inventory on hand or inventory turnover is expected. Any change greater than 5% will be subjected to additional inquiries.

Name of Account or Ratio: *Revenue*

Account or Ratio Expectation

5% to 10% increase.

Calculation and Comparison

Current Year	*Prior Year*	*Change*	*% Change*
$ 2,375,000	$ 2,175,000	$ 200,000	9.20 %

Additional Procedures or Conclusion

Change is within expected range.

Name of Account or Ratio: *Cost of Goods Sold*

Account or Ratio Expectation
5% to 10% increase.

Calculation and Comparison			
Current Year	*Prior Year*	*Change*	*% Change*
$ 1,780,000	$ 1,625,000	$ 155,000	9.54 %

Additional Procedures or Conclusion
Change is within expected range.

Name of Account or Ratio: *Interest Expense*

Account or Ratio Expectation
10% to 15% increase.

Calculation and Comparison			
Current Year	*Prior Year*	*Change*	*% Change*
$ 48,000	$ 42,000	$ 6,000	14.29 %

Additional Procedures or Conclusion
Change is within expected range.

Name of Account or Ratio: *Loans Payable*

Account or Ratio Expectation
10% to 15% increase

Calculation and Comparison			
Current Year	*Prior Year*	*Change*	*% Change*
$ 498,000	$ 437,000	$ 61,000	13.96 %

Additional Procedures or Conclusion
Change is within expected range.

Name of Account or Ratio: *Days Revenue in Accounts Receivable*

Account or Ratio Expectation
5% to 10% increase

Calculation and Comparison		
Current year days revenue in receivables	=	$1,600,000/($2,375,000/360)
	=	243 days
Prior year days revenue in receivables	=	$1,250,000/($2,175,000/360)
	=	207 days

Additional Procedures or Conclusion
The increase of 36 days revenue in accounts receivable (243 days – 207 days) represents a 17% increase. This increase is greater than the expected 5% to 10% increase. Discussions with Vista's management indicate that because new home starts are up, home builders have more need for cash flow up front and, consequently, have been slower to pay for their supplies. A comparison of last year's aged accounts receivables with this year's aged accounts receivables also indicates that home builders have been slower to pay.

Name of Account or Ratio: *Days of Inventory on Hand*

Account or Ratio Expectation
< 5% change.

Calculation and Comparison		
Current year days of inventory on hand	=	$1,100,000/($1,780,000/360)
	=	222 days
Prior year days of inventory on hand	=	$990,000/($1,625,000/360)
	=	219 days

Additional Procedures or Conclusion
Change is within expected range.

Name of Account or Ratio: *Inventory Turnover*

Account or Ratio Expectation
< 5% change.

Calculation and Comparison	
Current year inventory turnover	= $1,780,000/(($1,100,000 + $990,000)/2)
	= 1.7 times
Prior year inventory turnover	= $1,625,000/(($990,000 + $900,000)/2)
	= 1.7 times

Additional Procedures or Conclusion
Change is within expected range.

In a situation where no significant changes are expected, the accountant might document expectations as follows:

- Based on discussions with owner/manager, no significant changes from prior year amounts are expected.
- All increases/decreases greater than 5% will be subjected to additional procedures.

When the Results of Analytical Procedures Are Unfavorable

Although AR-C 90.30 (AR-C 90A.23) does not require the accountant to corroborate management's responses with other information, when results of analytical procedures are unfavorable (i.e., the accountant believes that fluctuations from expected amounts are significant or are inconsistent with other relevant information) the accountant may need to perform other procedures. AR-C 90.28 (AR-C 90A.21) states the accountant should investigate the differences by making inquiries of management and applying other procedures deemed necessary by the accountant. Additional procedures should be applied to determine whether or not any differences between expected and actual results are material adjustments that should be booked by the client and, if so, the amount that should be booked. These additional procedures may take the form of inquiries and additional analytical procedures. However, in many cases, accountants will combine additional inquiry or analytical procedures with preparing other accounting schedules or analyses to explain fluctuations. Differences between expected and actual results may be caused by imprecise expectations, and can be explained when additional procedures are performed.

When results of analytical procedures are unfavorable, the recorded amounts may be materially correct if the accountant's expectations were developed with incorrect assumptions. Accountants may need to reconsider the conditions or factors used in developing the expectations used in the analytical procedures. As discussed below, analytical procedures have certain limitations. For example, historical patterns of the entity can provide accountants with information to form expectations, but the accountant should take into consideration any current factors that could affect the expectations. The accountant may want to review their expectations that were developed and ensure there are not any additional valid conditions or factors that could alter those expectations.

Because of the nature of analytical procedures, it is usually not possible to explain the entire amount of the difference. An explanation of the exact amount of the difference is not necessary. It is only necessary to obtain a sufficient explanation to reduce the difference to an acceptable level. If, however, a satisfactory explanation of the difference cannot be obtained, other procedures will have to be performed to obtain limited assurance about the recorded amount.

Limitations of Analytical Procedures

Applying analytical procedures can be an effective method of identifying misstatements in financial statements. However, they do have certain limitations, including the following:

a. Inquiries may be more effective for certain assertions or accounts. For example, analytical procedures are ineffective when accounts are subject to significant management discretion, such as those involving estimates, because relationships are unpredictable. Similarly, it is difficult to obtain assurance about the assertions of existence or ownership through analytical procedures.

b. Analytical procedures are ineffective when factors affecting accounts are not constant over time.

c. Analytical procedures are less precise and accurate as account relationships become more remote.

d. Reasonableness tests usually depend to some extent on operating data, which may not be available.

e. Ratios may not be comparable with industry statistics, with ratios computed for other clients, or within the same client over time because of changes in accounting principles or because of differences in the way they are computed.

ADDRESSING RELATED PARTIES

SSARS No. 25 introduced new requirements to address related parties. AR-C 90.32 requires the accountant to be alert for information that may indicate the existence of related party relationships or transactions that have not been previously disclosed. If such information comes to light, AR-C 90.33 requires the accountant to inquire about the nature of the transactions and whether they could involve related parties.

ISSUES RELATED TO FRAUD AND NONCOMPLIANCE

SSARS No. 25 introduced new requirements relating to fraud and noncompliance with laws or regulations. According to AR-C 90.34–.35, procedures the accountant should perform after becoming aware that fraud or noncompliance with laws or regulations has occurred, or suspects that such fraud or noncompliance has occurred include the following:

- Communicate any findings or suspicions of fraud to the appropriate individual(s) within senior management or those charged with governance, if those involved are in senior management. (The communications are best delivered to management that is at least a level above that of the individual(s) involved or suspected of being involved in the fraud or noncompliance.)
- Communicate any findings or suspicions of significant noncompliance with laws or regulations affecting the financial statements.
- Request that management assess the effect on the financial statements of actual or alleged fraud or noncompliance with laws or regulations.
- Consider the effect of the management's assessment on the accountant's conclusion and the accountant's report.
- Determine whether the accountant has a responsibility to report any findings of fraud or noncompliance with laws or regulations to a third-party.

If management, or those charged with governance, do not provide information to a) support a conclusion that the financial statements are not materially misstated due to fraud or b) show that the entity is in compliance with laws and regulations that could have a material impact on the financial statements if the entity were not in compliance, then the accountant should seek legal counsel and take appropriate action, such as withdrawing from the engagement (AR-C 90.36).

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 statements best describes an aspect of designing and performing review procedures?

    a. The use of analytical procedures in a review engagement is the same as in an audit engagement.

    b. They are used to help an accountant obtain reasonable assurance that no material misstatements exist in the financial statements.

    c. They should be designed under the assumption that the financial statements are both correct and fairly stated.

    d. They should be focused on areas of the financial statements in which the client has a higher risk of misstatement.

2. *Trend analysis* involves which of the following?

    a. Studying the change in accounts over time.

    b. Estimating financial statement amounts or the change in amounts from last year.

    c. Identifying unusual relationships and individual items.

    d. Studying the relationship between a pair of financial statement amounts.

3. Which of the following is a limitation of using analytical procedures?

    a. Analytical procedures are often ineffective at helping accountants identify misstatements.

    b. Analytical procedures are ineffective with accounts that are inconsistent over the years.

    c. Inquiries are similarly effective for all assertions and accounts.

    d. Analytical procedures are only effective for accounts that have remote relationships.

SELF-STUDY ANSWERS

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

1. Which of the following statements best describes an aspect of designing and performing review procedures? **(Page 154)**

    a. The use of analytical procedures in a review engagement is the same as in an audit engagement. [This answer is incorrect. The use of analytical procedures in a review is *different* from the use of analytical procedures in an audit. The requirements are different and the procedures are used for different purposes.]

    b. They are used to help an accountant obtain reasonable assurance that no material misstatements exist in the financial statements. [This answer is incorrect. AR-C 90.24 and AR-C 90.A45 (AR-C 90A.17 and AR-C 90A.A34) state that the accountant should perform review procedures designed to accumulate sufficient appropriate review evidence that will provide a reasonable basis for obtaining limited assurance that there are no material modifications that should be made to the financial statements in order for the financial statements to be in conformity with the applicable financial reporting framework.]

    c. They should be designed under the assumption that the financial statements are both correct and fairly stated. [This answer is incorrect. The analytical procedures, inquiries, and other procedures performed should be designed based on the accountant's understanding of the industry, knowledge of the client, and awareness of the *risk* that the financial statements may be materially misstated.]

    d. **They should be focused on areas of the financial statements in which the client has a higher risk of misstatement. [This answer is correct. The accountant should focus the analytical procedures and inquiries in those areas where the accountant believes there are increased risks of misstatements. For example, if the client has terminated some of its franchise agreements, the accountant may need to tailor review procedures to assess whether to report discontinued operations and to consider impairment, going concern implications, and costs to exit activities. Another area that might merit increased focus is account balances that are subject to management estimate.]**

2. *Trend analysis* involves which of the following? **(Page 157)**

    a. **Studying the change in accounts over time. [This answer is correct. *Trend analysis* is a type of analytical procedure that involves the study of the change in accounts over time. For example, when comparative financial statements are presented, accountants often compare current year amounts with those of the prior year. That is the simplest form of trend analysis. Comparisons of amounts for several successive years, however, are generally more reliable and useful.]**

    b. Estimating financial statement amounts or the change in amounts from last year. [This answer is incorrect. *Reasonableness tests* (not trend analysis) are those that estimate a financial statement amount or the change in amount from the prior year. Generally, reasonableness tests use operating or other nonfinancial data; however, sometimes they use only financial information.]

    c. Identifying unusual relationships and individual items. [This answer is incorrect. Analytical procedures as a whole should assist the accountant in identifying relationships and individual items that appear unusual. Often, the analytical procedures can identify problem areas in the financial statements that are not always evident when the financial statements are merely read by the accountant. However, while trend analysis is one type of analytical procedure and can help accountants make this type of identification, there is a more specific answer related to trend analysis itself that is a better answer to this question.]

d. Studying the relationship between a pair of financial statement amounts. [This answer is incorrect. *Ratio analysis* (not trend analysis) involves the study of the relationship between two financial statement amounts. Ratios generally assess an aspect of (1) operations, (2) financial position, or (3) operations as related to financial position.]

3. Which of the following is a limitation of using analytical procedures? **(Page 168)**

   a. Analytical procedures are often ineffective at helping accountants identify misstatements. [This answer is incorrect. Applying analytical procedures can be an effective method of identifying misstatements in financial statements. They do have some limitations, but an overall difficulty of identifying misstatements is not one of them.]

   b. **Analytical procedures are ineffective with accounts that are inconsistent over the years. [This answer is correct. One of the limitations that affect an accountant's use of analytical procedures is that they are ineffective when factors affecting accounts are not constant over time. Therefore, they would be less effective for inconsistent accounts.]**

   c. Inquiries are similarly effective for all assertions and accounts. [This answer is incorrect. One of the limitations inherent in the use of analytical procedures is that inquiries may be more effective for certain assertions or accounts. For example, analytical procedures are ineffective when accounts are subject to significant management discretion, such as those involving estimates, because relationships are unpredictable. Similarly, it is difficult to obtain assurance about the assertions of existence or ownership through analytical procedures.]

   d. Analytical procedures are only effective for accounts that have remote relationships. [This answer is incorrect. Analytical procedures are less precise and accurate (not more effective) as account relationships become more remote.]

CONSIDERATIONS RELATED TO GOING CONCERN

AR-C 90.37 (AR-C 90A.65) states that if 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 (such as in GAAP), the accountant is required to *perform procedures*—

- to determine whether the going concern basis of accounting is appropriate,
- on management's evaluation of whether there are conditions or events that raise substantial doubt about the entity's ability to continue as a going concern,
- on management's plans to mitigate such doubts (if applicable), and
- to determine the adequacy of the related financial statement disclosures.

The accountant is not required to perform procedures aimed at identifying conditions or events that raise substantial doubt about the entity's ability to continue as a going concern. However, the accountant may identify such conditions or events either because such conditions or events existed at the date of the prior financial statements or because of inquiries the accountant made or procedures the accountant performed as part of the current period review engagement.

AR-C 90.A64 (AR-C 90A.A116) indicates the nature and extent of the going concern review procedures are a matter of professional judgment and will vary depending on the circumstances. For example, if the client has a history of profitability and easy access to financing, inquiry might be a sufficient review procedure to determine the entity's ability to continue as a going concern for a reasonable period of time.

According to AR-C 90.38 (AR-C 90A.66), if the applicable financial reporting framework does *not* include requirements for management to evaluate the entity's ability to continue as a going concern (such as the cash basis of accounting) and the accountant either (a) becomes aware of conditions or events that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time [within one year after the date the financial statements are issued (or within one year after the date that the financial statements are available to be issued, when applicable) based on AR-C 90.08 (AR-C 90A.05)] or (b) such conditions or events existed at the date of the prior financial statements (regardless of whether the substantial doubt was alleviated), the accountant is required to *inquire* of management about whether the going concern basis of accounting is appropriate, *inquire* of management about its plans for addressing the adverse effects of the conditions or events, and consider the adequacy of the related disclosures.

AR-C 90.60j (AR-C 90A.34m) requires management representation related to going concern for all review engagements whether or not there is a going concern uncertainty. It is a best practice to include that representation in the representation letter. There are also reporting considerations if there are uncertainties about the entity's ability to continue as a going concern. Those considerations are discussed in Lesson 2.

REQUIRED COMMUNICATION OF SIGNIFICANT MATTERS

AR-C 90.18 (AR-C 90A.13) requires the accountant to communicate, on a timely basis, with management or those charged with governance regarding significant matters that arise during the engagement procedures. Matters to be communicated may include, but are not limited to, the following:

- The accountant's views about qualitative aspects of the entity's accounting policies, accounting estimates, and financial statement disclosures.
- Significant findings from the performance of review procedures, including findings that caused the accountant to consider or perform additional procedures.
- Matters that led to modifying the accountant's review report.
- Significant difficulties the accountant experienced during the performance of the review engagement.

Although these communications may be written or oral, AR-C 90A.95 requires the accountant to document *in writing* any communications with management or those charged with governance concerning fraud or noncompliance with laws and regulations. SSARS No. 25 (AR-C 90.138) requires the accountant to document communications with management, those charged with governance, and others about significant matters arising during the engagement, including the nature of such matters. Such matters include communications with management or those charged with governance concerning fraud or noncompliance with laws and regulations.

The timing of the communications may vary with the different circumstances of the matters that need to be communicated, such as the significance and nature of the matter and the accountant's expectations of management to perform any actions related to the matter. In some circumstances, laws or regulations may prohibit the accountant to communicate certain matters with management or those charged with governance. In those circumstances, accountants may consider obtaining legal advice.

DEALING WITH UNSATISFACTORY INFORMATION

While performing review procedures, the accountant may become aware of information that is incorrect, incomplete, or otherwise unsatisfactory. If this occurs, the accountant should ask management to consider the effect of these matters on the financial statements and to communicate the results of their findings to the accountant. The accountant should then consider the effect management's findings might have on the accountant's review report. If the accountant believes the financial statements could be materially misstated, AR-C 90A.30 requires the accountant to apply additional procedures sufficient to achieve limited assurance that no material modifications are necessary to conform the financial statements with the applicable financial reporting framework. SSARS No. 25 also requires the accountant to design and perform additional procedures if the accountant becomes aware of information that indicates the financial statements may be materially misleading; however, AR-C 90.42 states that the additional procedures should be performed to determine whether or not the financial statements as a whole are materially misstated. After implementing SSARS No. 25, if the accountant believes sufficient appropriate review evidence has not been obtained, the accountant should perform additional procedures deemed necessary to form a conclusion on the financial statements. (AR-C 90.47) According to AR-C 90.48, the accountant should withdraw from the engagement if unable to obtain sufficient appropriate review evidence to form a conclusion.

DETERMINATION AND DOCUMENTATION OF MATERIALITY

Pre-SSARS No. 25 guidance requires practitioners to consider materiality in planning a review engagement, but does not require materiality to be documented. From a practical standpoint, most practitioners use professional judgment when considering materiality for planning purposes in a review engagement. That is, practitioners scan account balances and classes of transactions in the financial statements or in the trial balance to determine where analytical procedures and inquiries should be performed. In that process, they focus on account balances and classes of transactions that may be prone to misstatements that would make a difference to users of the reviewed financial statements. Analytical procedures and inquiries are not required to be performed on account balances and classes of transactions or related disclosures that are small and qualitatively insignificant.

SSARS No. 25 (AR-C 90.19–.20) explicitly requires the accountant to determine (and thus document) materiality for the financial statements as a whole and apply materiality in designing procedures and evaluating the results of the procedures performed. Further, the accountant is required to revise materiality if the accountant becomes aware of information that would have resulted in a different initial materiality amount.

For additional information on materiality, see the discussion in Lesson 2 which is entitled "What is a Material GAAP Departure?"

ACCUMULATING AND EVALUATING PASSED ADJUSTMENTS

AR-C 90.65 requires accountants to consider the effect of current and prior uncorrected misstatements on the financial statements as a whole when forming a conclusion. Prior to implementing SSARS No. 25, AR-C 90A.27–.28 requires the accountant to accumulate and evaluate, individually and in the aggregate, misstatements, including inadequate disclosure, to determine whether material modifications should be made to the financial statements for

them to be in accordance with the applicable financial reporting framework. When evaluating materiality, AR-C 90A.A49 indicates consideration should be given to—

- The nature, cause, and amount of the misstatements.
- Whether the misstatements existed in the prior year.
- Whether it is appropriate to offset an estimated misstatement with a precise misstatement.
- The potential effect of the misstatements on future periods.
- Whether the accumulation of immaterial misstatements could become material in future periods.

In most small business review engagements, the client records the majority (if not all) of the adjusting entries proposed by the accountants. Significant differences in expectations and recorded amounts when applying analytical procedures are generally followed up with inquiries and/or additional procedures to explain the difference. Sometimes additional procedures are performed to isolate the potential misstatement. For that reason, it is usually not necessary in a review engagement for accountants to accumulate passed adjustments to determine their impact on the financial statements. Consequently, practitioners seldom prepare a summary of differences worksheet or similar document.

Although the authors believe that it is both conservative and prudent to encourage the client to book all misstatements or adjustments in a review engagement, if passed adjustments do exist, AR-C 90.60l (AR-C 90A.34i)i requires that a summary of such adjustments be included in, or attached to, the management representation letter.

In evaluating the materiality of adjustments, the practitioner should not use the estimate of planning materiality, which is used to determine the nature, timing, and extent of review procedures to be applied, to determine whether an adjustment (individually or combined with other adjustments) is material. Evaluation materiality is different from planning materiality.

In evaluating adjustments, the practitioner should consider the adjustments in relation to individual accounts (e.g., accounts receivable) and subtotals (e.g., current income), not to their relationship to planning materiality. The practitioner should also evaluate the passed adjustments from a qualitative perspective. For example, a small adjustment may be particularly sensitive to the users of the financial statements and, therefore, material. Of course, evaluation materiality, which consists of quantitative and qualitative assessments, has to be viewed from the perspectives of the financial statement users and whether the amount or disclosure would be important to the decisions that users would be making.

In summary, the authors recommend that—

a. All adjustments should be booked by the client. If significant differences in expectations and recorded amounts are noted when applying analytical procedures, such differences should be followed up with inquiries and/or additional procedures to explain the difference, or additional procedures should be performed to isolate the potential misstatement.

b. If all adjustments are not booked, the practitioner should evaluate the adjustments that are not booked by assessing their materiality (individually and in combination) in relation to individual accounts, subtotals, and totals in the financial statements.

c. Do not use planning materiality for the evaluation in item b above.

d. Finally, also evaluate the adjustments from a qualitative materiality perspective.

READING THE ENTITY'S REVIEWED FINANCIAL STATEMENTS

AR-C 90.31 (AR-C 90A.24) requires the accountant to read the financial statements and consider whether they conform with the applicable financial reporting framework based on the information the accountant acquires while performing the review. Though outside the scope of this course, more in-depth information about reading the financial statements is provided in *PPC's Guide to Compilation and Review Engagements*.

CONSIDERATIONS FOR USING THE WORK OF OTHERS

When the accountant decides to use work of other accountants or experts in the course of the review engagement, AR-C 90.39 requires the accountant to ensure that the work performed is adequate for the accountant's purposes. If other accountants have issued a report on significant components (divisions, branches, subsidiaries, partnerships, or joint ventures in which the entity has a significant investment), AR-C 90.40 (AR-C 90A.25) requires that the accountant obtain and read reports from the other accountants as a basis, in part, for his or her report on his or her review of the financial statements of the entity.

As discussed in Lesson 2, when other accountants have audited or reviewed a component of the reporting entity but the accountant of the reporting entity does not assume responsibility for the audit or review of the other accountants, the accountant of the reporting entity is required to make reference to the work of the other accountants in the accountant's report. According to AR-C 90.124 (AR-C 90A.81), regardless of whether the accountant decides to make reference to the work of other accountants in the review report, the accountant should communicate with the other accountants and ascertain the following:

a. The other accountants are aware that the division, branch, subsidiary, or other investee financial statements that have been audited or reviewed are to be included in the financial statements on which the accountant will report and the accountant will rely upon the other accountants' report.

b. The other accountants are familiar with the applicable financial reporting framework and applicable professional standards (SSARS or GAAS) and will conduct the review or audit in accordance with such. [A review report stating the review was conducted in accordance with SSARS or an audit report stating the review was conducted in accordance with GAAS would be sufficient to ascertain whether those standards were followed. If different review or audit standards were followed, the guidance at AR-C 90.A194 (AR-C 90A.A138) may be useful in making the determination.]

c. The other accountants understand the independence and other ethical requirements pertaining to the engagement. Although not required by SSARS, the accountant may want to obtain a written confirmation of the other accountants' independence.

d. Intercompany transactions and accounts will be reviewed for matters that might affect appropriate eliminations and matters affecting the uniformity of accounting practices among the components included in the financial statements will be reviewed.

AR-C 90.138 (AR-C 90A.94) states that the review engagement documentation should include the communications with the other accountants listed in the previous paragraph.

Referring to reports of other accountants in the review report is discussed in Lesson 2.

COMMUNICATING INTERNAL CONTROL RELATED MATTERS

AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, establishes the auditor's responsibility to communicate significant deficiencies and material weaknesses in an entity's internal control. It requires the auditor to inform management and those charged with governance of any significant deficiencies and material weaknesses in the design or operation of internal control. AU-C 265, however, does not apply to either a compilation or review engagement. AR-C 90.A4 (AR-C 90A.A4) explicitly states that "a review does not contemplate obtaining an understanding of the entity's internal control." This course suggests including a sentence clarifying that the accountant's engagement "cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by fraud or error, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations." It is important for the client to understand that those are not the same as significant deficiencies and material weaknesses; rather, that significant deficiencies and material weaknesses in an entity's internal control may permit errors, fraud, and noncompliance with laws and regulations to occur. Thus, some accountants prefer to clarify in the engagement letter that they have no responsibility, in a review engagement, to

communicate deficiencies in the entity's internal control. Because of that situation, the following language often is included in review engagement letters:

> We have no responsibility to identify and communicate deficiencies or material weaknesses in your internal control as part of this engagement.

In the case of *Robert Wooler Co. v. Fidelity Bank* (Pennsylvania Superior Court, June 29, 1984), a company sustained a loss when an employee misappropriated cash receipts, and the company's accounting firm was held liable for failing to inquire about the system of internal control, which apparently facilitated the theft. Unfortunately, the case has been widely quoted as placing a duty on accountants to report detected control deficiencies to clients in unaudited engagements. In this particular case, however, the accounting firm, as a matter of practice, instructed employees to be alert for possible improvements in client's accounting policies and procedures, systems of control, and duties assigned to accounting personnel. The firm also had a policy to inquire into the allocation of the client's bookkeeping duties. Some knowledgeable attorneys believe that the court decision cannot be generalized and that failure to comply with the accounting firm's own policies regarding internal control was a principal reason behind the court's finding. The SSARS do not require accountants to inquire into internal control matters or to communicate deficiencies in internal control. Thus, the authors continue to believe that an accountant has no obligation in compilation and review engagements beyond client service considerations (unless expressly agreed to) to inquire about internal control matters or to communicate deficiencies in internal control.

CONSIDERATIONS FOR REPRESENTATION LETTERS

The SSARS require accountants to request a written representation from management for all financial statements and periods covered by the accountant's review report. The specific written representations obtained by the accountant will depend on the individual engagement circumstances and the nature and basis of the presentation of the financial statements.

AR-C 90.60 (AR-C 90A.34) requires that, in connection with a review of financial statements, the management representation letter should address the following matters:

- Management's acknowledgment that it has fulfilled its responsibility for the preparation and fair presentation of the financial statements of financial position, results of operations, and cash flows in accordance with the applicable financial reporting framework, as set out in the terms of the engagement.
- Management's acknowledgement of its responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements, including its responsibility to prevent and detect fraud.
- Management has provided all relevant information and access.
- Management's acknowledgement of full and truthful responses to all inquiries.
- All transactions have been recorded and have been properly reflected in the financial statements.
- Disclosure to the accountant significant facts about any known fraud or suspected fraud affecting the entity involving management, employees, or others where the fraud could have a material effect on the financial statements.
- Management has disclosed to the accountant significant facts about any known allegations of fraud or suspected fraud communicated by current or former employees, regulators, or others that could have an affect on the financial statements.
- Management has disclosed to the accountant all known actual or possible instances of noncompliance with laws and regulations that should be considered when preparing the financial statements.
- Management's belief that the effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. In addition, AR-C 90.60l (AR-C 90A.34i) also requires a summary of uncorrected misstatements to be included in, or attached to, the representation letter. The authors believe that in most small business review engagements, the client will record the

adjusting entries proposed by the accountant and, therefore, there generally will be no uncorrected misstatements.

- Management has disclosed to the accountant all known actual or possible litigation or claims whose effect should be considered when preparing the financial statements and properly accounted for and disclosed such litigation and claims in the financial statements.
- Whether management believes that the significant assumptions used in making the accounting estimates are reasonable.
- Management has disclosed the identity of known related parties and all known related party relationships and transactions and has properly accounted for and disclosed those relationships and transactions in the financial statements.
- Management has disclosed to the accountant all information supporting the use of the going concern assumption in the financial statements.
- Subsequent events are properly disclosed and accounted for in the financial statements.

Reasons for Obtaining a Representation Letter

In some cases, accountants who request representation letters on review engagements may encounter resistance from their nonaudit clients, primarily because they do not understand the purpose of the representation letter or the matters discussed in the letter. The primary reasons for obtaining a representation letter in a review engagement should be explained to the small business owner/manager, as follows:

a. Management is being asked to acknowledge its primary responsibility for the financial statements. Even if the accountant prepared the statements prior to reviewing them, they are the primary responsibility of management. (The letter does not change or add to management's fundamental responsibilities, nor does it relieve the accountants of their responsibilities. It simply clarifies the traditional roles that each perform.)

b. The representation letter avoids misunderstandings, serves as a *memory jogger*, and provides a list of important matters that may affect the financial statements.

Modifications to the Standard Letter

A client representation letter is usually prepared by the accountant, but it is a communication from the client to the accountant and is signed by client management. When using a representation letter adapted from AR-C 90.A215 (AR-C 90A.A159), such as the one presented in *PPC's Guide to Compilation and Review Engagements*, it may be advisable to modify some of the standard wording to make the owner/manager more comfortable with the reasonableness of the representations being requested. AR-C 90.61 (AR-C 90A.35) states that additional representations should be obtained if they are needed to support the review evidence obtained.

Additional Representations. Certain additional representations may be advisable in the representation letter. For example, if the client operates in a specialized industry, the accountant should modify the letter by including additional representations contained in the *AICPA Audit and Accounting Guides* relating to that industry. Examples are provided in *PPC's Guide to Construction Contractors*, *PPC's Guide to Homeowner's Associations and Other Common Interest Realty Associations*, and *PPC's Guide to Audits of Nonprofit Organizations*. Paragraph 1.163 of the AICPA Guide: *Preparation, Compilation, and Review Engagements* (AICPA Guide) includes numerous illustrative representations that apply in specific circumstances.

Refusal to Furnish a Representation Letter

As previously noted, the accountant is required to request a representation before issuing a review report. If the client refuses to provide a representation letter, the review engagement is considered incomplete and there will not be an adequate basis for issuing a review report. In these instances, some accountants have questioned whether it would be appropriate to step-down the engagement and issue a compilation report instead. Paragraph 2.95 of the AICPA Guide states that the accountant would ordinarily be precluded from changing the engagement type and issuing a compilation report on those financial statements. Even though a compilation report offers no assurance, the

accountant should not be associated with statements that may be misleading and thus should resign from the engagement. Lesson 2 discusses instances when step-downs from a review to a compilation would be appropriate.

Periods Covered by the Representation Letter

According to AR-C 90.60 (AR-C 90A.34), representation letters should include all periods covered by the accountant's report. In other words, if the accountant is reporting on comparative financial statements, the representations obtained at the completion of the most recent review should address all periods being reported on. The SSARS requires the accountant to obtain representations for all periods covered by the review report from those who have the appropriate responsibilities for the financial statements and knowledge of the matters concerned.

According to AR-C 90.A97 (AR-C 90A.A62), there may times when current management was not present during all periods covered by the accountant's report, and as such believe they are not in a position to provide some or all of the representations. However, the fact that current management was not present for all periods does not relieve them of their responsibilities for the financial statements as a whole. Consequently, the requirement for the accountant to obtain written representations from management that cover all periods covered by the accountant's report still applies.

Date of the Representation Letter

AR-C 90.60 (AR-C 90A.34) states that management's representations set forth in the representation letter should be made as of the date of the accountant's review report. However, the representation letter itself should be dated as of the date that the letter is presented and signed by the client. But, in no event should the letter be presented and signed prior to the date of the accountant's review report since the accountant is concerned with events occurring up to the date of the accountant's review report. Paragraph 1.162 of the AICPA Guide states that the accountant need not 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. However, the accountant would need to be in physical receipt of the letter prior to the *release* of the review report.

Who Signs the Representation Letter? The accountant is required to obtain representations from those who have the appropriate responsibilities for the financial statements and knowledge of the matters concerned. Typically, this is the CEO, CFO, or other member of management with similar responsibilities.

Updating Representation Letters

There are circumstances in which accountants should consider obtaining updating representation letters from management. For instance, significant time may lapse between when the accountant obtains a management representation letter after completion of the review procedures and when the accountant issues his or her report; or a material subsequent event may occur after the representation letter is obtained but prior to issuance of the report. In addition, if a predecessor accountant is asked by a former client to reissue his or her report on the financial statements of a prior period, and those financial statements are to be presented on a comparative basis with reviewed financial statements of a subsequent period, the predecessor accountant should obtain an updating representation letter before reissuing a report on financial statements of a prior period. The updating management representation letter should address (a) whether management is aware of any new information that would cause them to believe that any of the previous representations should be modified and (b) whether any events occurring subsequent to the latest balance sheet date of the financial statements reported on by the predecessor require disclosure in or adjustment to such financial statements.

LEGAL REPRESENTATION LETTERS

Unlike an audit engagement, SSARS do not require the accountant to obtain a legal representation letter (see AU-C 501, *Audit Evidence—Special Considerations for Selected Items*). The authors believe that requesting a letter would be rare and would occur only in situations where the accountant had questions or unresolved issues regarding a material disclosure or amount in the reviewed financial statements pertaining to litigation, claims, or assessments, which could be resolved by obtaining a legal representation letter. In such situations, when the accountant determines that a legal representation letter is needed, but is prevented from obtaining the letter by the client, the authors believe consideration should be given to withdrawing from the engagement and not issuing a review report.

INITIAL REVIEW ENGAGEMENTS

Auditing standards set forth specific requirements for initial audits; no such requirements, however, exist for initial reviews. The review performance requirements listed at the beginning of this lesson apply for both initial review engagements and recurring review engagements. The difference lies in which analytic procedures are performed and what inquiries are made. The accountant should use judgment to make these determinations. In addition, although not required unless the successor accountant believes prior-period financial statements require revision, the authors believe that the successor accountant should communicate with the predecessor accountant.

Analytical Procedures on Initial Engagements

Practitioners often question how to apply analytical procedures on initial engagements. For example, how can an accountant evaluate the results of procedures applied for the current year if he or she is unsure whether amounts are comparable with prior years or if the company is newly formed? The authors believe it is reasonable to conclude that procedures may be modified in initial engagements (or engagements in which the company has insufficient history for such procedures to be meaningful). In initial review engagements, accountants often must rely on making additional inquiries, preparing the financial statements, or providing other accounting services to supplement the limited analytical procedures that can be performed in an initial engagement because of insufficient history.

Analytical procedures on initial engagements can consist of comparisons with public information for similar clients or to industry statistics, and of analysis of the interrelationships between accounts such as an analysis of selling expenses to sales. However, in those cases, accountants should pay particular attention to the limitations of analytical procedures described earlier in this lesson.

SELF-STUDY QUIZ

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

4. Which of the following should be addressed in a representation letter for a review engagement?

    a. Management's acknowledgement of its responsibility for designing and performing review procedures.

    b. Justification for any significant assumptions used when making accounting estimates that might be considered unreasonable.

    c. That management believes the effects of uncorrected misstatements, individually and in the aggregate, are immaterial to the financial statements as a whole.

    d. Management omits all information about its related parties from the representation letter due to privacy concerns.

5. What is one of the biggest differences between an initial review engagement and a recurring review engagement?

    a. Professional standards set specific requirements that must be met in an initial review engagement.

    b. Different analytical procedures may be performed and different inquiries may be made.

    c. Communication with predecessor auditors is required in an initial review engagement.

    d. A legal representation letter will not be necessary in the initial review engagement.

SELF-STUDY ANSWERS

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

4. Which of the following should be addressed in a representation letter for a review engagement? **(Page 176)**

    a. Management's acknowledgement of its responsibility for designing and performing review procedures. [This answer is incorrect. The accountant is responsible for the design and performance of review procedures. One of the matters covered by a representation letter should be management's acknowledgement of its responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements, including its responsibility to prevent and detect fraud.]

    b. Justification for any significant assumptions used when making accounting estimates that might be considered unreasonable. [This answer is incorrect. One of the matters that should be addressed in the representation letter is whether management believes that the significant assumptions used in making the accounting estimates are reasonable. Unreasonable assumptions could not be made acceptable simply be mentioning them in the representation letter.]

    c. **That management believes the effects of uncorrected misstatements, individually and in the aggregate, are immaterial to the financial statements as a whole. [This answer is correct. As discussed in AR-C 90.60 (AR-C 90A.34), one of the issues addressed in the representation letter should be management's belief that the effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole.]**

    d. Management omits all information about its related parties from the representation letter due to privacy concerns. [This answer is incorrect. Management's representation letter should address whether management has disclosed the identity of known related parties and all known related party relationships and transactions and has properly accounted for and disclosed those relationships and transactions in the financial statements. Omitting all such information would not be appropriate.]

5. What is one of the biggest differences between an initial review engagement and a recurring review engagement? **(Page 179)**

    a. Professional standards set specific requirements that must be met in an initial review engagement. [This answer is incorrect. Auditing standards set forth specific requirements for initial audits; *no* such requirements, however, exist for initial reviews. Review performance requirements are the same for both initial and recurring review engagements.]

    b. **Different analytical procedures may be performed and different inquiries may be made. [This answer is correct. The biggest difference between an initial review engagement and a recurring review engagement lies in which analytical procedures are performed and what inquiries are made. The accountant should use judgment to make these determinations.]**

    c. Communication with predecessor auditors is required in an initial review engagement. [This answer is incorrect. This course recommends that successor accountants communicate with predecessor accountants in an initial review engagement; however, this communication is not required by the authoritative guidance.]

    d. A legal representation letter will not be necessary in the initial review engagement. [This answer is incorrect. Unlike an audit engagement, the SSARS do not require the accountant to obtain a legal representation letter. This course suggests that requesting a letter would be rare and would occur only in situations where the accountant had questions or unresolved issues regarding a material disclosure or amount in the reviewed financial statements pertaining to litigation, claims, or assessments, which could be resolved by obtaining a legal representation letter. Therefore, as there is no specific

requirement for legal representation letters for any type of review engagement, not obtaining one for an initial engagement is not a difference of note. Therefore, there is a better answer to this question.]

Lesson 2: Reporting on Compiled or Reviewed Financial Statements

INTRODUCTION

This lesson discusses a variety of issues that may arise when reporting on compiled or reviewed financial statements.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify reporting obligations for compiled and reviewed statements, requirements for reporting, levels of service, and dating reports.
- Determine methods for dealing with a lack of independence; financial statements that omit substantially all disclosures, the statement of cash flows or comprehensive income; GAAP departures; scope limitations; single financial statements; supplementary information; and charts and graphs.
- Recognize requirements for reporting on comparative financial statements, accounting changes, nonprofit organizations, and governmental entities.
- Identify other reporting situations that may occur with compiled or reviewed financial statements.

AN ACCOUNTANT'S REPORTING OBLIGATION

Statements on Standards for Accounting and Review Services (SSARS) discuss the accountant's reporting obligations for compilation and review engagements. In summary—

a. If an accountant performs a compilation, a written report is required. [AR-C 80.17 (AR-C 80A.17)]

b. If an accountant performs a review, a written review report is required. [AR-C 90.75 (AR-C 90A.38)]

The SSARS also provide a non-reporting option in AR-C 70 (AR-C 70A). AR-C 70 (AR-C 70A) applies whenever an accountant is engaged to prepare financial statements other than in a limited number of situations. More information on AR-C 70 (AR-C 70A, *Preparation of Financial Statements*), and when it applies can be found in *PPC's Guide to Compilation and Review Engagements* and in *PPC's Guide to SSARS Preparation Engagements*.

Financial Statements Prepared in Accordance with International Standards

The International Accounting Standards Board (IASB) has been designated by the Council of the AICPA as the body to establish international financial reporting standards. Consequently, an accountant may apply the reporting guidance in the SSARS when engaged to report on financial statements presented in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB). These reports would read the same as the standard SSARS reports, except that the basis of accounting noted in the report would be, "in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board." In addition, IFRS requires an entity to present comparative financial information. Consequently, accountants who compile or review financial statements that omit prior year information should disclose the omission in the accountant's report as a departure from IFRS as issued by the IASB. Paragraph 1.241, Illustration 12, of the AICPA Guide presents an illustrative accountant's review report on comparative financial statements prepared in accordance with international financial reporting standards issued by the IASB when the review is performed in accordance with Statements on Standards for Accounting and Review Services and International Standard on Review Engagements 2400.

According to Paragraph 1.202 of the AICPA Guide, an entity may prepare financial statements in conformity with a financial reporting framework generally accepted in another country where the entity's financial statements do not

comply with International Financial Reporting Standards as issued by the International Accounting Standards Board (that is, a jurisdictional variation of IFRS). In these instances, the accountant should report in accordance with the SSARS and identify the financial reporting framework generally accepted in the other country. The accountant may report using the other country's standard report provided all of the required SSARS reporting elements are included. Because of the nature of the basis of the presentation of these financial statements, there is a presumption that the report may be misunderstood or taken out of context. Consequently, a restriction on the use of the report would be included. Paragraph 2.102, Illustration 11, of the AICPA Guide presents an illustrative compilation report on comparative financial statements prepared in accordance with a financial reporting framework generally accepted in another country. Paragraph 1.241, Illustration 13, of the AICPA Guide presents an illustrative review report on comparative financial statements prepared in accordance with a financial reporting framework generally accepted in another country. See the discussion of AR-C 100 and its guidance on performing engagements on financial statements prepared in accordance with a financial reporting framework generally accepted in another country below.

Furthermore, AR-C 60.A27 (AR-C 60A.A26) allows an accountant who performs a compilation or review of historical financial statements of a U.S. entity to follow another set of compilation or review standards (such as ISRS 4410, ISRE 2400, or compilation or review standards of another country), in addition to the required SSARS standards. Paragraph 1.241, Illustration 11, of the AICPA Guide presents an illustrative review report for such situations.

AR-C 100, *Special Considerations—International Reporting Issues*. AR-C 100, *Special Considerations—International Reporting Issues*, provides guidance and requirements for accountants who are engaged to perform a compilation or review in one of the following situations:

- The compilation or review will be performed in accordance with the SSARS *and* another set of compilation or review standards.
- The compilation or review will be performed on financial statements prepared in accordance with a financial reporting framework generally accepted in another country not adopted by a body designated by AICPA Council to establish GAAP (such as a jurisdictional variation of International Financial Reporting Standards). (Financial statements prepared in accordance with IFRS without jurisdictional variations may be reported on as noted above.)

AR-C 100 was effective for compilations and reviews of financial statements for periods ending on or after June 15, 2019, and withdrew AR-C 90A, Interpretation No. 1, Considerations Related to Reviews Performed in Accordance With International Standard on Review Engagements (ISRE) 2400 (Revised), *Engagements to Review Historical Financial Statements*.

If faced with one of these situations, accountants should generally follow the guidance in AR-C 60 (AR-C 60A) and AR-C 80 (AR-C 80A) or AR-C 90 (AR-C 90A), as applicable. AR-C 100 only addresses the special considerations necessary to comply with AR-C 60 (AR-C 60A) and AR-C 80 (AR-C 80A) or AR-C 90 (AR-C 90A) when compiling or reviewing financial statements in accordance with the SSARS and a set of international standards, or compiling or reviewing financial statements prepared in accordance with a financial reporting framework generally accepted in another country. These special considerations include—

- Engagement acceptance.
- Planning and performing the engagement.
- Reporting on the financial statements.

Engagement Acceptance. As a condition for accepting an engagement, AR-C 60.A26a (AR-C 60A.26b) requires the accountant to determine whether the financial reporting framework selected by management to be used in the preparation of the financial statements is acceptable. For a compilation or review of financial statements prepared in

accordance with a financial reporting framework generally accepted in another country, the accountant should obtain an understanding of the following:

- The reason the financial statements are being prepared.
- Whether the financial reporting framework to be used in the preparation of the financial statements is a *fair presentation framework*.
- The intended users of the financial statements.
- The steps taken by management to determine that the financial reporting framework chosen is acceptable in the circumstances.

If the compilation or review will be performed in accordance with the SSARS and another set of compilation or review standards, the financial statements are intended for use only outside of the United States, and the accountant plans to use the international standards for the form and content of the accountant's compilation or review report; then the accountant should obtain an understanding of the legal responsibilities involved when performing the engagement in accordance with both the SSARS and the other set of compilation or review standards.

Planning and Performing the Engagement. When an accountant performs a compilation or review on financial statements prepared in accordance with a financial reporting framework generally accepted in another country, the accountant should obtain an understanding of the framework used.

When an accountant performs a compilation or review in accordance with the SSARS and another set of compilation or review standards, the accountant should obtain an understanding and apply the other standards, as well as the SSARS.

Reporting on the Financial Statements. If an accountant is issuing an accountant's compilation or review report on financial statements that is intended for use only *outside the United States*, the accountant should use one of the following:

a. A report that is in accordance with the SSARS and includes both of the following:

   (1) The report elements required by AR-C 80 (AR-C 80A) or AR-C 90 (AR-C 90A), as applicable, except for the requirement to include a paragraph about financial statements prepared in accordance with a special purpose framework [AR-C 80.21 (AR-C 80A.21) and AR-C 90.77 (AR-C 90A.43)].

   (2) A statement that refers to the financial statement note (if substantially all disclosures are not omitted) that describes the basis of presentation of the financial statements and identifies the country of origin of the accounting principles used when the financial statements are prepared using a financial reporting framework generally accepted in another country.

b. A report that is in accordance with another set of compilation or review standards, provided that all of the following are true:

   (1) Such a report would be issued by accountants in the other country in a similar situation.

   (2) If a review engagement is performed, the accountant has obtained sufficient appropriate review evidence to support the review report conclusion.

   (3) The accountant has complied with the other compilation or review reporting standards and identifies them in the report.

If an accountant is issuing an accountant's compilation or review report on financial statements that is intended for use *in the United States*, the accountant should report in accordance with the SSARS, including the requirements related to financial statements prepared in accordance with a special purpose framework [AR-C 80.21 (AR-C 80A.21) and AR-C 90.77 (AR-C 90A.43)].

When the accountant conducts a compilation or review in accordance with both the SSARS and another set of compilation or review standards, the accountant's report should refer to both the SSARS and the other set of

standards, and identify the other set of standards and its origin. AR-C 100 contains numerous illustrative reports that may be used in these reporting situations.

CONSIDERATIONS FOR COMPILATION REPORTS

AR-C 80.17 (AR-C 80A.17) requires a written report on a 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.

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.

Some accountants choose to modify the compilation report by separating the standard paragraph into more than one paragraph. There is nothing in the standards that precludes accountants from doing so. However, ARSC specifically chose to make the standard compilation report only be one paragraph and not include a title in order to help distinguish it from review reports and audit reports, since no assurance is provided in a compilation engagement and some level of assurance is provided in both reviews and audits.

CONSIDERATIONS FOR REVIEW REPORTS

Per SSARS No. 25, when forming the review conclusion on the financial statements, the accountant should— (AR-C 90.64–.66)

a. Evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

b. Consider whether—

(1) The titles of the financial statements and terminology used in the financial statements are consistent with the applicable financial reporting framework.

(2) The accounting policies selected are appropriate and consistent with the applicable financial reporting framework.

(3) Management's accounting estimates appear reasonable.

(4) The information presented in the financial statements appears relevant, reliable, comparable, and understandable.

(5) The financial statements provide adequate disclosures to enable the intended users to understand the effects of material transactions and events on the information conveyed in the financial statements.

(6) The financial statements adequately disclose the significant accounting policies applied.

(7) The financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

c. Consider—

(1) The impact on the financial statements of uncorrected misstatements identified during the current year's review and the prior year's review.

(2) Indicators of possible management bias in judgments and other qualitative aspects of the entity's accounting practices.

(3) The overall presentation, structure, and content of the financial statements.

Form of Conclusion

Unmodified Conclusion. Per SSARS No. 25, the accountant should express an unmodified conclusion in the accountant's review report when the accountant has obtained limited assurance that nothing has come to their attention that leads them to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework. Unless required differently by law or regulation, the accountant should use the following language when expressing an unmodified conclusion—(AR-C 90.67–.68)

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

The review report conclusion requirements when the accountant's conclusion has *not* been modified is the same both before and after implementing SSARS No. 25.

Modified Conclusion. Per SSARS No. 25 (AR-C 90.71), the accountant should express a modified conclusion in the accountant's review report when the accountant determines that the financial statements are materially misstated. There are two types of modified conclusions—

> 1. *Qualified conclusion*. The accountant should express a qualified conclusion when the financial statements are materially misstated, but the misstatement is *not* pervasive to the financial statements.
>
> 2. *Adverse conclusion*. The accountant should express an adverse conclusion when the financial statements are materially misstated and the misstatement is pervasive to the financial statements.

Modified conclusions require two sections in the accountant's review report— (AR-C 90.70)

a. A conclusion paragraph, which uses the heading "Qualified Conclusion" or "Adverse Conclusion," as appropriate.

b. A basis for conclusion paragraph, which appears immediately before the conclusion paragraph, provides a description of the matter giving rise to the modification, and uses the heading, "Basis for Qualified Conclusion" or "Basis for Adverse Conclusion," as appropriate.

When expressing a qualified conclusion on the financial statements, unless required differently by law or regulation, the accountant should use the following language—(AR-C 90.72)

> Based on my (our) review, except for the effects of the matter(s) described in the Basis for Qualified Conclusion paragraph, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

Prior to implementing SSARS No. 25, accountants generally use qualified conclusions when there are departures from the applicable financial reporting framework. However, the term *qualified conclusion* is not used and separate basis of qualified conclusion section is not required.

When expressing an adverse conclusion on the financial statements, unless required differently by law or regulation, the accountant should use the following language—(AR-C 90.73)

> Based on my (our) review, due to the significance of the matter(s) described in the Basis for Adverse Conclusion paragraph, the financial statements are not in accordance with accounting principles generally accepted in the United States of America.

In the basis of conclusion paragraph, the accountant should—(AR-C 90.74)

a. Describe and quantify the effects of the misstatement (departure) on the financial statements, if known. If the effects of the departure are not known, the accountant is not required to determine the effects of the departure, but should state in the report that such determination has not been made by management.

b. Explain how disclosures are misstated, if the material misstatement relates to narrative disclosures.

c. Describe the nature of the omitted information, if the material misstatement relates to the nondisclosure of information required to be disclosed. The accountant should include omitted disclosures when possible.

Reporting

AR-C 90.76 (AR-C 90A.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 based on the circumstances of the engagement.

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 the 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 relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

e. Includes a section with the heading "Accountant's Responsibility" that includes:

   - A statement that the accountant's responsibility is to conduct the review engagement 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 as a basis for reporting 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;
- A statement that the accountant believes the results of the accountant's procedures provide a reasonable basis for the accountant's conclusion; and
- After implementing SSARS No. 25, a statement that the accountant is required to be independent of the entity and to meet the accountant's other ethical responsibilities, in accordance with the relevant ethical requirements relating to the review.

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. SSARS No. 25 requires a concluding section with a heading that includes the accountant's unmodified conclusion on the financial statements or modified conclusion on the financial statements, as appropriate, and that identifies the country of origin of the financial reporting framework, if applicable.

g. After implementing SSARS No. 25 (AR-C 90.70), when the accountant's conclusion on the financial statements is modified:

- Use the heading "Qualified Conclusion" or "Adverse Conclusion," as appropriate for the conclusion paragraph.
- Describe the matter or matters giving rise to the modification under an appropriate heading. An appropriate heading would be "Basis for Qualified Conclusion" or "Basis for Adverse Conclusion."

h. Include the signature of the accounting firm or the accountant.

i. Include the city and state where accountant practices.

j. 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. SSARS No. 25 states that the accountant's report should be dated no earlier than the date the accountant has obtained sufficient appropriate review evidence as the basis for the accountant's conclusion on the financial statements. Both before and after implementing SSARS No. 25, prior to dating the accountant's review report, evidence must be obtained that:

- Financial statements and related notes have been prepared and
- Management has accepted responsibility for the financial statements and related notes.

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.

PROVIDING DIFFERENT LEVELS OF SERVICE

Reporting When Additional Procedures are Performed

AR-C 80.A18 (AR-C 80A.A18) provides guidance addressing when the accountant performs procedures that go beyond those required in a compilation. In other words, if a practitioner is engaged to compile financial statements but decides to apply analytical procedures and make inquiries, is a review report required? In response, the guidance at AR-C 80 (AR-C 80A) indicates "no."

AR-C 90.A45 (AR-C 90A.A34) addresses whether an accountant can perform audit procedures in a review engagement and still issue a review report. For instance, if a client requests that the accountant confirm accounts receivable in addition to reviewing year-end financial statements, will the engagement need to be changed to an

audit? Guidance at AR-C 90 (AR-C 90A) indicates "no." The accountant is not to mention in the report or accompanying notes to the financial statements that accounts receivable were confirmed. Also, the confirmations would not be worded to imply that they are part of audit procedures.

In these situations, the accountant needs to place additional importance on the understanding with the client regarding the nature of services to be rendered. In the authors' opinion, the key factor in determining what level of service is to be reported on is knowing what the practitioner was *engaged to perform*. Documenting the service the practitioner was engaged to perform is most easily done with an engagement letter that meets the requirements of AR-C 80.10 (AR-C 80A.10) or AR-C 90.16 (AR-C 90A.11).

Change in Level of Service. Sometimes the level of service first sought by the client is not obtained and a lower level is requested, e.g., when review procedures are incomplete, and a compilation report is requested. An in-depth discussion of such a change is outside the scope of this course, but more information is available in *PPC's Guide to Compilation and Review Engagements*.

AR-C 90.10 (AR-C 90A.07) prohibits the issuance of a review report if the accountant is not independent. However, the issuance of a compilation report is permitted when the accountant is not independent [(AR-C 80.22 (AR-C 80A.22)]. This could be one instance when a step-down engagement is permissible. The accountant would issue a compilation report on financial statements of an entity with respect to which he or she is not independent even though he or she has adhered to all other standards for a review engagement. Likewise, if an accountant is not independent with respect to an audit engagement of a nonpublic entity client, he or she may issue a compilation report. No mention would be made in the compilation report of any additional review or audit procedures performed.

Compiling Financial Statements for a Prescribed Form after Performing a Review or Audit. Another unique reporting situation is when an accountant who has reviewed or audited the financial statements of a nonpublic entity is engaged to issue a compilation report on financial statements for the same period that are included in a prescribed form. According to Paragraphs 2.48-.49 of the AICPA Guide, the accountant's compilation report on the prescribed form may refer to the accountant's review or auditor's report if the only difference between the compiled statements included in the prescribed form and the previously reviewed or audited statements is the omission of disclosures and, while not required, the accountant may add an other-matter paragraph to the accountant's compilation report which states that full disclosure financial statements were audited or reviewed and include a reference to the corresponding auditor's or accountant's review report on those full disclosure financial statements.

Different Levels of Service on Financial Statements of the Same Period

CPAs may be asked to perform a level of service that might be viewed as lower than the one they previously performed on financial statements covering the same period. Examples of such situations are:

- The client requests the CPA to compile financial statements that omit substantially all disclosures, even though the CPA already has compiled, reviewed, or audited full-disclosure financial statements for the same period.
- The client requests the CPA to compile a balance sheet that omits substantially all disclosures, even though the CPA already has compiled, reviewed, or audited the complete financial statements for the same period.

Clients generally make such requests because, particularly in financial statements of small businesses, the notes include information about such things as profit sharing and related party transactions. If the financial statements are being provided to certain parties, such as suppliers, clients may prefer not to make that type of information available.

Many practitioners will consent to providing the compilation as long as they are satisfied that the client has a valid business reason for the request and that the step-down would, in the accountant's professional judgment, not mislead the financial statement users. If the CPA believes, however, that there is no valid business reason for the client's request, the CPA should refuse to perform the compilation as supported by AR-C 80.26 (AR-C 80A.26).

If the CPA agrees to provide the compilation engagement, questions frequently arise about the form of the report. The most common question is whether the accountant should refer in the compilation report to the prior level of

service performed on the statements. Because professional standards are silent on this issue, practice varies. Presently, there appear to be two schools of thought on the issue:

- Some accountants believe that a standard compilation report, modified by adding an explanatory paragraph describing the lack of disclosures, would be issued. Thus, they believe no mention is made in the report of the prior compilation, review, or audit of the full-disclosure financial statements. This is particularly true, they believe, for situations in which the financial statements were previously audited since users might infer a higher level of assurance because of the prior engagement.

- Other accountants believe that the CPA's compilation report needs to disclose the existence of a complete set of (full-disclosure) compiled, reviewed, or audited financial statements in a paragraph such as the following:

  > These financial statements were (This financial statement was) compiled by me (us) from (full-disclosure) financial statements for the same period that I (we) previously compiled (or reviewed or audited) as indicated in my (our) report dated January 30, 20XX.

  Such disclosure, they argue, is necessary to protect CPAs from claims that they withheld information or participated in a deceit (if, for example, the client, without the CPA's knowledge, told the financial statement user that audited financial statements are not available).

The compilation discussed above is considered a new and separate engagement. Thus, the authors believe that no mention of the prior engagement need be made in the accountant's compilation report. However, before consenting to the client's request, the CPA should ensure himself or herself that the client has a valid business reason for the request and that the step-down would, in the accountant's professional judgment, not mislead financial statement users.

DATING COMPILATION AND REVIEW REPORTS

Dating Compilation Reports

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 (AR-C 80A.17i)]. The authors believe that completion of a compilation generally takes place on the date the financial statements are *read*, as the term is used in AR-C 80.13 (AR-C 80A.13). In practice, many accountants simply use the typing date as the date of the accountant's report. Other accountants use the date the financial statements were drafted. As a practical matter, the date probably has little bearing on the accountant's legal liability in a compilation engagement.

Dating Review Reports

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 90A.39i). SSARS No. 25 states that the accountant's review report should be dated no earlier than the date on which the accountant has obtained sufficient appropriate review evidence as the basis for the accountant's conclusion on the financial statements (AR-C 90.76j). 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. Consequently, the review report and management representation letter should be dated on the same day. 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 accountant's review report [AR-C 90.A99 (AR-C 90A.A64)]. The authoritative guidance does not specifically address a time period or time limit between the dating of the accountant's report on reviewed financial statements and when it is released. However, the authors believe the accountant's report should be released as soon as reasonably possible after the date of the report; and if there is a delay in releasing the report, the accountant should consider whether they should obtain an updated management representation letter.

Reporting on Comparative Financial Statements

When a continuing accountant *updates* a previously issued report for purposes of reporting on comparative financial statements, the report on the comparative statements should be dated when the work is completed on the current period financial statements.

When an accountant *reissues* a previously issued report for purposes of reporting on comparative financial statements, the report should bear the original date of the report unless financial statements have been revised, in which case the reissued report should be dual-dated. Updated, reissued, and dual-dated reports are discussed later in this lesson.

SELF-STUDY QUIZ

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

6. Harry accepts an engagement to review financial statements prepared under International Financial Reporting Standards (IFRS). His report will be used in the United States. Harry will need to do which of the following?

    a. Harry will need to report in accordance with the SSARS.

    b. Harry should use a set of international compilation and review standards instead of the SSARS.

    c. Harry must refer to both the SSARS and another set of compilation and review standards in his report.

    d. Harry will need to perform the review in accordance with alternative compilation and review standards.

7. Under the SSARS, a report on reviewed financial statements should include which of the following?

    a. An "Accountant's Responsibility" section taking responsibility for fair presentation of the financial statements.

    b. The signatures of all key members of management as well as those charged with governance.

    c. An introductory paragraph that includes the identity of the accounting firm that will review the financial statements.

    d. A conclusion with a heading that states whether the accountant is aware of any material modifications needed for the financial statements.

8. When would it most likely be permissible for an accountant to step down a review engagement and issue a compilation report instead?

    a. The accountant performs additional analytical procedures.

    b. The accountant is no longer independent from the reviewed entity.

    c. The accountant performs a certain number of auditing procedures.

    d. There is a client-imposed scope limitation on the engagement.

SELF-STUDY ANSWERS

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

6. Harry accepts an engagement to review financial statements prepared under International Financial Reporting Standards (IFRS). His report will be used in the United States. Harry will need to do which of the following? **(Page 187)**

    a. **Harry will need to report in accordance with the SSARS. [This answer is correct. If an accountant is issuing an accountant's compilation or review report on financial statements that is intended for use *in the United States*, like Harry, the accountant should report in accordance with the SSARS, including the requirements related to financial statements prepared in accordance with a special purpose framework.]**

    b. Harry should use a set of international compilation and review standards instead of the SSARS. [This answer is incorrect. If an accountant is issuing an accountant's compilation or review report on financial statements that is intended for use only *outside the United States*, the accountant can choose whether to report in accordance with the SSARS or in accordance with another set of compilation or review standards, if certain criteria are met.]

    c. Harry must refer to both the SSARS and another set of compilation and review standards in his report. [This answer is incorrect. When the accountant conducts a compilation or review in accordance with both the SSARS and another set of compilation or review standards, the accountant's report should refer to both the SSARS and the other set of standards, and it should also identify the set of standards and its origin. This requirement always applies under these circumstances and is not contingent upon whether or not the resulting report will be used in the United States.]

    d. Harry will need to perform the review in accordance with alternative compilation and review standards. [This answer is incorrect. When an accountant performs a compilation or review in accordance with the SSARS and another set of compilation or review standards, the accountant should obtain an understanding and apply the other standards, as well as the SSARS. However, using alternative standards is not mandatory when the report will be used in the United States.]

7. Under the SSARS, a report on reviewed financial statements should include which of the following? **(Page 190)**

    a. An "Accountant's Responsibility" section taking responsibility for fair presentation of the financial statements. [This answer is incorrect. The "Management's Responsibility" section should include a statement that management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework. The "Accountant's Responsibility" section of a review report includes other information.]

    b. The signatures of all key members of management as well as those charged with governance. [This answer is incorrect. The review report should include the signature of the accounting firm or the accountant. Signatures of members of management or those charged with governance are not required.]

    c. An introductory paragraph that includes the identity of the accounting firm that will review the financial statements. [This answer is incorrect. The review report is required to have an introductory paragraph that, among other things, includes the identity of the entity whose financial statements have been reviewed. Information about the accounting firm does not go in this paragraph.]

    d. **A conclusion with a heading that states whether the accountant is aware of any material modifications needed for the financial statements. [This answer is correct. AR-C 90.76 (AR-C 90A.39) requires that a report on reviewed financial statement include certain items. One such item is 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.]

8. When would it most likely be permissible for an accountant to step down a review engagement and issue a compilation report instead? **(Page 192)**

   a. The accountant performs additional analytical procedures. [This answer is incorrect. AR-C 80.A18 (AR-C 80A.A18) provides guidance addressing when the accountant performs procedures that go beyond those required in a compilation. In other words, if a practitioner is engaged to compile financial statements but decides to apply analytical procedures and make inquiries, is a review report required? In response, the guidance at AR-C 80 (AR-C 80A) indicates "no." Performing analytical procedures, however, is part of a review engagement and, therefore, would not be a reason to step-down the level of such an engagement.]

   b. **The accountant is no longer independent from the reviewed entity. [This answer is correct. AR-C 90.10 (AR-C 90A.07) prohibits the issuance of a review report if the accountant is not independent. However, the issuance of a compilation report is permitted when the accountant is not independent. This could be one instance when a step-down engagement is permissible. The accountant would issue a compilation report on financial statements of an entity with respect to which he or she is not independent even though he or she has adhered to all other standards for a review engagement.]**

   c. The accountant performs a certain number of auditing procedures. [This answer is incorrect. AR-C 90.A45 (AR-C 90A.A34) addresses whether an accountant can perform audit procedures in a review engagement and still issue a review report. For instance, if a client requests that the accountant confirm accounts receivable in addition to reviewing year-end financial statements, will the engagement need to be changed to an audit? Guidance at AR-C 90 (AR-C 90A) indicates "no." The accountant is not to mention in the report or accompanying notes to the financial statements that accounts receivable were confirmed. Also, the confirmations would not be worded to imply that they are part of audit procedures. Additionally, even if the accountant were to change the engagement to an audit, that would be a step up from a review and not a step down.]

   d. There is a client-imposed scope limitation on the engagement. [This answer is incorrect. In deciding whether it would be appropriate to issue a compilation report when a scope restriction precludes a review report, the accountant needs to determine if the scope restriction is client-imposed. AR-C 80.16 (AR-C 80A.16) requires that the accountant withdraw from the engagement if the client refuses to provide additional or revised information; therefore, a step-down in the engagement would not be appropriate.]

REPORTING WHEN THE ACCOUNTANT IS NOT INDEPENDENT

An accountant is precluded from issuing a review report on the financial statements of an entity with respect to which he is not independent. The accountant may, however, issue a compilation report, provided he or she complies with the compilation standards.

The accountant's compilation report should specifically disclose the lack of independence [AR-C 80.22 (AR-C 80A.22)]. When the accountant is not independent, he or she should include the following as the last paragraph of the compilation report:

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

Some accountants add this paragraph as a conservative practice. Accountants that 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 may 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. The authors believe 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. In general, the authors believe the accountant should not disclose the lack of independence unless a specific independence issue has been identified.

AR-C 80.23 (AR-C 80A.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 should be disclosed.) The authors recommend that the accountant simply add the paragraph illustrated above without stating why independence is impaired. The rationale behind this recommendation is that it may reduce litigation risk. 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 [AR-C 80.23 (AR-C 80A.23)]. 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 3, 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* [AR-C 80.A8 (AR-C 80A.A8)]. One aspect of determining independence that is often overlooked is the effect of uncollected client fees.

FINANCIAL STATEMENTS THAT OMIT SUBSTANTIALLY ALL DISCLOSURES

Financial statements that omit substantially all disclosures may be compiled by the accountant provided the accountant's report discloses the omission, and the omission, in the accountant's professional judgment, would not mislead those who might reasonably be expected to use the financial statements. Since the omission of material disclosures is a departure from the applicable financial reporting framework, the accountant's report should clearly

indicate the departure. AR-C 80.27 (AR-C 80A.27) indicates that a separate paragraph should be added to the compilation report stating—

> Management has elected to omit substantially all the disclosures (and the statement of cash flows, if applicable) required by accounting principles generally accepted in the United States of America. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the Company's financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

When the entity wishes to include disclosures about only a few matters in the form of notes to the compiled financial statements, such disclosures may be labeled "SELECTED INFORMATION—Substantially All Disclosures Required by Accounting Principles Generally Accepted in the United States of America Are Not Included." The additional paragraph in the accountant's compilation report is still necessary.

The modification for compiled financial statements discussed in the previous paragraph is not appropriate for reviewed financial statements. That is, a general statement to the effect that substantially all disclosures have been omitted is not appropriate for reports on reviewed financial statements.

Because of these reporting requirements, an accountant ordinarily would not accept an engagement to review financial statements that omit substantially all disclosures. When an accountant who undertakes to compile financial statements in which 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 80A.26). SSARS No. 25 clarifies this by stating that the accountant should not issue an accountant's compilation report on financial statements that omit substantially all disclosures required by the applicable financial reporting framework if, in the accountant's professional judgment, such financial statements would be misleading to users of the financial statements (AR-C 80.26).

In a compilation that omits substantially all disclosures, what constitutes *substantially*? AR-C 80.28 (AR-C 80A.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 (AR-C 80A.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 example, when the financial statements include all material notes except one, the guidance discussed in this section for reporting on financial statements that omit substantially all disclosures is not appropriate. AR-C 80 (AR-C 80A) and AR-C 90 (AR-C 90A) provide guidance for reporting on financial statements that include a departure from the applicable financial reporting framework in compiled and reviewed statements, respectively. Reporting on financial statements containing departures from the applicable reporting framework is discussed in more detail later in this lesson.

WHEN THE STATEMENT OF CASH FLOWS OR COMPREHENSIVE INCOME IS OMITTED

Omission of Statement of Cash Flows

According to FASB ASC 230-10, when a business enterprise or nonprofit organization presents both a balance sheet and a statement of operations (income statement), a statement of cash flows should also be presented as a basic financial statement. A statement of cash flows should be presented for each period for which an income statement is presented. Thus, omitting the statement of cash flows constitutes a departure from the applicable financial reporting framework. (Exceptions are financial statements prepared in accordance with a special purpose framework,

presentations that exclude either the balance sheet or statement of income, prescribed forms, and personal financial statements.) Like other departures from the applicable financial reporting framework, the accountant discloses the departure in a separate paragraph of his or her report. An example of the wording of the separate paragraph is as follows:

> A statement of cash flows for the year ended December 31, 20X1, has not been presented. Accounting principles generally accepted in the United States of America require that such a statement be presented when financial statements purport to present financial position and results of operations.

Omission of Statement of Cash Flows and Substantially All Disclosures Omitted. Under AR-C 80.27 (AR-C 80A.27), when an accountant reports on financial statements that omit substantially all disclosures *and* the statement of cash flows, the report does not disclose the omitted statement of cash flows as a separate departure from the applicable financial reporting framework.

Omission of Comprehensive Income

Not reporting comprehensive income, as required, constitutes a departure from the applicable financial reporting framework. If the accountant compiles financial statements that include all disclosures but omit the display of comprehensive income, the omission should be treated as a departure from the applicable financial reporting framework as described in the previous paragraph.

Omission of Display of Comprehensive Income and Substantially All Disclosures Omitted. According to AR-C 80.29 (AR-C 80A.29), when the accountant becomes aware of a departure from the applicable financial reporting framework, including the financial disclosures, the accountant should modify the compilation report to disclose the departure. When substantially all disclosures are not included, the display of comprehensive income may be omitted by identifying the omission in the compilation report.

WHEN FINANCIAL STATEMENTS HAVE DEPARTURES FROM GAAP (EXCLUDING PRESCRIBED FORMS AND SPECIAL-PURPOSE FRAMEWORK PRESENTATIONS NOT IN CONFORMITY WITH GAAP)

The previous two sections discuss the accountant's reporting obligation when the financial statements omit substantially all disclosures, the statement of cash flows, or comprehensive income. This section discusses reporting on financial statements with measurement or disclosure departures from GAAP. (As previously mentioned, the omission of a single footnote is also treated like a GAAP departure.)

What Is GAAP?

FASB ASC 105-10 establishes the *FASB Accounting Standards Codification* (Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with United States GAAP. FASB ASC 105-10-05 states that the GAAP hierarchy includes only two levels of GAAP: authoritative and nonauthoritative, with authoritative GAAP being all accounting guidance contained in the Codification. All other accounting literature is considered to be nonauthoritative.

Many firms refer to a GAAP disclosure checklist to ensure that they have considered all appropriate GAAP disclosures on financial statement preparation, compilation, and review engagements. Two GAAP disclosure checklists are provided in *PPC's Guide to Compilation and Review Engagements*. *PPC's Guide to Preparing Financial Statements* and *PPC's Guide to GAAP* are also excellent reference sources for applying both GAAP measurement and GAAP disclosure standards. Those *Guides* may be ordered by calling (800) 431-9025 or at **tax.thomsonreuters.com**.

What Is a *Material* GAAP Departure?

Materiality is a term used to describe the significance of a departure from generally accepted accounting principles. Only material departures require correction. Determining what is material to the financial statements taken as a whole is one of the most difficult decisions in the accounting profession.

Chapter 3 of the Statement of Financial Accounting Concepts No. 8, as amended, defines *materiality* as the omission or misstatement of an item in the financial statements that is large enough or significant enough that it is probable a reasonable person relying on the information would change their judgement or would be influenced by the inclusion or correction of the item. While materiality and relevance are both dependent on what influences or makes a difference to a user of the financial statements, relevance is a general notion, while materiality is entity-specific. The nature of the item and entity-specific circumstances should be considered when assessing the magnitude of materiality. That is, magnitude, alone, is generally not a sufficient basis for making a materiality decision. Also, there are no general guidelines that can encompass all considerations that influence judgments made by an experienced, reasonable provider of financial information.

Lesson 1 included a discussion on documenting materiality. Though outside the scope of this course, *PPC's Guide to Compilation and Review Engagements* includes a discussion of materiality as it relates to the SSARS. Some might argue that the guidance is nebulous, but a more definite statement is probably impossible since materiality is a matter of judgment in the circumstances.

Alternatives When Faced with a GAAP Departure

Although management may elect to omit substantially all disclosures required by GAAP in compiled financial statements, such an election does not apply to reviewed financial statements. However, management may elect to omit a few disclosures in reviewed financial statements. The omission of any material *disclosures* from reviewed financial statements is considered a GAAP departure. In those instances, the accountant includes in the review report the omitted disclosures or, if the details to be disclosed have not been determined, the specific nature of the omitted disclosures. If, in the course of a compilation or review engagement, the accountant becomes aware of material *measurement* departures from GAAP, they have several possible courses of action:

a. persuade the client to revise the statements to conform with GAAP,

b. refer to the departure in the report,

c. after implementing SSARS No. 25, for review reports, if the departure is pervasive, issue an "Adverse Conclusion," or

d. withdraw from the engagement.

Revision of the statements is, of course, the preferred course of action. If revision is not feasible, reporting the departure in the accountant's report is appropriate unless the practitioner, in their professional judgment, concludes that reporting the departure would mislead the reader. If modification of 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 (AR-C 80A.32) and AR-C 90.A106 (AR-C 90A.59)].

For review reports prior to implementing SSARS No. 25 and for compilation reports both before and after implementing SSARS No. 25, if modification of the accountant's report is appropriate, the nature of the departure from GAAP should be disclosed in a separate paragraph, and the effects (dollar amount) of the departure should be disclosed, if known [AR-C 80.30 (AR-C 80A.30) and AR-C 90A.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 (AR-C 80A.31) and AR-C 90A.58]. For review reports after implementing SSARS No. 25, the accountant's report should be modified for the departure. The next section in this lesson discusses reporting when the effects of the departure are not determined.

ET 1.320 of the AICPA *Code of Professional Conduct* addresses a rare situation in which accountants are associated with financial statements that contain a departure from GAAP because compliance with GAAP would result in misleading financial statements. ET 1.320.001, "Accounting Principles Rule," states that in audit and review

engagements if it can be demonstrated that, due to unusual circumstances, the financial statements or other financial data would have been misleading without the departure, the accountant will not be in violation of the accounting principles rule, provided that the accountant describes the departure, its approximate effects, and the reasons why compliance with the principle would result in a misleading statement. The authors believe that the "unusual circumstances" in ET 1.320.001 would rarely, if ever, occur. The accountant would have to justify the GAAP departure, and that justification would be difficult and would likely subject the accountant to criticism.

Paragraph 1.192 of the AICPA Guide explains that if financial statements contain a departure from the applicable financial reporting framework in order to keep the financial statements from being misleading, the standard review report does not need to be modified, except for the addition of a separate paragraph or paragraphs which describe the departure, its approximate effects (if practicable), and the reasons why complying with the applicable financial reporting framework principles would be misleading. However, ET 1.320.001 does not apply to a compilation engagement. Therefore, the authors believe that when confronted with this situation in a compilation engagement, the accountant would treat the item as a departure from GAAP and report accordingly. AR-C 80.29 (AR-C 80A.29) indicates when the accountant becomes aware of a departure from the applicable financial reporting framework that is material to the financial statements that is not disclosed in the notes to the financial statements, the accountant should modify the compilation report to disclose the departure.

WHEN THERE ARE SIGNIFICANT DEPARTURES FROM GAAP (EXCLUDING PRESCRIBED FORMS AND SPECIAL-PURPOSE FRAMEWORK PRESENTATIONS NOT IN CONFORMITY WITH GAAP)

According to AR-C 80A.A38 and AR-C 90A.A107, 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 conclusion is not appropriate in a compilation or review engagement prior to the implementation of SSARS No. 25. SSARS No. 25 (AR-C 90.68), however, allows an adverse conclusion in a review report when there is evidence of pervasive and material misstatement of the financial statements. SSARS No. 25 is effective for engagements for periods ending on or after December 15, 2021, with early implementation permitted. SSARS No. 25 can be adopted on an engagement by engagement basis; but an accountant cannot apply SSARS No. 25 and issue a report with an adverse conclusion for an engagement without adopting the other amendments of SSARS No. 25 for that engagement.

According to Paragraph 2.71 of the AICPA Guide and AR-C 90A.A108, prior to implementing SSARS No. 25, the accountant may wish to emphasize the limitations of financial statements having significant GAAP 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 effects of the departures.

b. The significance of the affected items to the entity.

c. The pervasiveness and overall impact of the misstatement.

d. Whether disclosure has been made of the effects of the departure.

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, results of operations, and cash flows if they had access to revised financial statements prepared in accordance with accounting principles generally accepted in the United States of America.

The separate other-matter paragraph, which generally would be presented as the last paragraph of a review report, might read as follows:

> **Limitations of the Financial Statements**
>
> Because the significance and pervasiveness of the matters described in the Known Departures From Accounting Principles Generally Accepted in the United States of America 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 accounting principles generally accepted in the United States of America.

Use of an other-matter paragraph is optional. The authors believe it should only be used 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.

After implementing SSARS No. 25, for review engagements, when the departures are significant and pervasive, the accountant would issue an adverse conclusion instead.

WHEN THERE IS A SCOPE LIMITATION

Scope limitations occur in audit engagements when the auditor is prevented from applying GAAS because of limitations imposed by the client or caused by circumstances. When an auditor encounters a scope limitation, he issues either an *except for* opinion or a disclaimer of opinion. However, the SSARS do not permit such reporting.

Scope limitations also can occur in SSARS engagements, especially in initial review engagements. In those cases, it is not unusual for the accountant to raise questions about the reasonableness of amounts included in the financial statements. Often, due to the timing of the engagement or inadequate accounting records, the accountant also may be unable to apply analytical procedures to obtain review assurance. AR-C 90.A109 (AR-C 90A.A68) notes that when an accountant is unable to perform the inquiry and analytical procedures necessary for a review or when the client does not furnish a representation letter, the review will be incomplete and a review report cannot be issued.

In considering the implications of the scope limitation, the accountant needs to evaluate the possibility that the information affected by the scope restriction is incorrect, incomplete, or otherwise unsatisfactory. This evaluation is a matter of professional judgment. The authors believe that if the client is *unable* to provide additional or revised information due to factors beyond his control, a step-down from a review to a compilation is usually acceptable. The accountant considers the following:

a. Whether the reason for the scope limitation seems logical.

b. Whether the scope restriction significantly impairs the usefulness of the financial statements.

In deciding whether it would be appropriate to issue a compilation report when a scope restriction precludes a review report, the accountant needs to determine if the scope restriction is client-imposed. AR-C 80.16 (AR-C 80A.16) requires that the accountant withdraw from the engagement if the client refuses to provide additional or revised information. The authors believe a scope restriction resulting from inadequate accounting records would normally be considered a client-imposed scope restriction. Although the restriction may be unintentional, the maintenance of adequate accounting records is within the client's control. Situations where the client is *unable* to provide additional or revised information (for which a step-down may be appropriate, as described in the preceding paragraph) are rare. One such situation would be when accounting records have been destroyed. Even in that case, the accountant would be required to provide other accounting services to reconstruct significant transactions prior to compiling the financial statements.

When there has been a restriction that precludes a review report and the accountant decides to issue a compilation report, he or she would issue an appropriate compilation report without any reference to the scope restriction. The Accounting and Review Services Committee (ARSC) concluded that describing the scope limitation that precluded the issuance of a review report might imply that review procedures had been performed, causing the user to place undue reliance on the report.

If an accountant is unable to obtain the limited assurance required for a review and decides it would not be appropriate to issue a compilation report or prepare financial statements, he or she may try to provide other accounting information to the client. For example, a working trial balance may satisfy the client's needs. Conversely, the accountant may be able to perform an agreed-upon procedures engagement and report accordingly.

REPORTING ON FINANCIAL STATEMENTS THAT ARE INCLUDED IN CONSULTING SERVICES REPORTS

Unaudited historical financial statements are often included in reports on findings in Consulting Services (CS) engagements. A question often arises as to what reporting responsibility the CPA/consultant has on those historical statements. Accountants may report on the historical financial statements included in CS engagements, but a SSARS report is not necessarily required. Accountants may be engaged to prepare the historical financial statements rather than compiling or reviewing those statements. In these instances, there would be no report. When preparing the historical financial statements that are included with the CS engagement findings, accountants should follow the guidance in AR-C 70 (AR-C 70A). Consulting services engagements and the related reporting requirements are discussed in *PPC's Guide to Small Business Consulting Engagements*, which may be ordered online at **tax.thomsonreuters.com** or by calling (800) 431-9025.

WHEN ONLY ONE FINANCIAL STATEMENT IS PRESENTED

An accountant may issue a *compilation* report on a single financial statement such as a balance sheet. Likewise, he or she may issue a *review* report on a single financial statement. Engagements to report on single financial statements are limited reporting engagements, not scope restrictions.

WHEN SUPPLEMENTARY INFORMATION IS PRESENTED

What Is the Definition of Supplementary Information?

The term *supplementary information* (also commonly referred to as "other," "additional," or "accompanying" information) is defined in SSARS literature. According to AR-C 80.05 (AR-C 80A.05) and AR-C 90.08 (AR-C 90A.05), supplementary information includes 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. Such information may be presented in a document containing the reviewed or compiled financial statements or separately from the reviewed or compiled financial statements.

Thus, the authors believe that nonaccounting as well as accounting information is *supplementary information* subject to the requirements of the SSARS. In the authors' opinion, however, supplementary information does not include multiple income statements (e.g., month-to-date and quarter-to-date; quarter-to-date and year-to-date; multiple quarters-to date and year-to-date) included in a set of computer-prepared financial statements. Such income statements are historical financial statements and, accordingly, would be reported on by the accountant. (The accountant may identify the income statements being reported on by either listing them in the body of the report or by listing them in an index and referring to "the financial statements included in the foregoing index.")

In summary, the authors recommend that—

a. Schedules providing detail of line items in the basic financial statements be considered supplementary information.

b. All supplementary information be placed after the basic financial statements and notes and, ordinarily, be preceded by a title page marked "SUPPLEMENTARY INFORMATION."

c. If the client wishes to provide detail of line items in the basic financial statements and insists that the detail be part of the basic financial statements, present the detail on the face of the financial statement, considering the amount of detail and whether it is practical to present all of the detail on the face of the financial statements.

Supplementary Information Accompanying Compiled Financial Statements

SSARS require that the accountant indicate the degree of responsibility, if any, he or she is taking with respect to the supplementary information that accompanies historical financial statements that he or she has compiled. If the supplementary information has been compiled by the accountant, an other-matter paragraph would be added to the standard compilation report that reads as follows. Headings are not needed in compilation reports. Consequently, 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 the 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. The authors believe that this report is applicable when the client has prepared the supplementary information and it is bound with the accountant's report. See the discussion below.

Supplementary Information Accompanying Reviewed Financial Statements

When *reviewed* financial statements are accompanied by supplementary information (whether prepared by the accountant or by the client), AR-C 90.126–.128 (AR-C 90A.83–.85) require 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 in order for it to be in conformity with the applicable financial reporting framework.

e. The accountant has not audited the supplementary information and, accordingly, does not express an opinion on such information.

Pre-SSARS No. 25 (AR-C 90A.54) requires the other matter paragraph to follow the conclusion paragraph and any emphasis of matter paragraphs, if applicable. SSARS No. 25 (AR-C 90.91) does not prescribe a placement for the other matter paragraph.

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.

Pre-SSARS No. 25 (AR-C 90A.54) requires the other matter paragraph to follow the conclusion paragraph and any emphasis of matter paragraphs, if applicable. SSARS No. 25 (AR-C 90.91) does not prescribe a placement for the other matter paragraph.

Although not addressed in AR-C 90 (AR-C 90A), there is nothing to preclude an accountant from compiling supplementary information accompanying reviewed financial statements. This would be similar to the situation described in AR-C 90.129a (AR-C 90A.86a) for required supplementary information. If the supplementary information is compiled, the accountant would modify the wording in the other-matter paragraph described in the previous paragraph to include a statement to that effect.

Client-prepared Supplementary Information

Client-prepared supplementary information is normally included with compiled or reviewed financial statements in one of the following ways: (a) the financial statements and the client-prepared information are bound by the accountant in the firm's report cover (or typed on the accountant's watermark paper and stapled to the financial statements) or (b) after the accountant submits the financial statements to the client, the client in turn attaches (in some manner) supplementary information and distributes the package to third parties.

Client-prepared Supplementary Information Bound in the Accountant's Report Cover. When client-prepared supplementary information is bound in the accountant's report cover, the authors believe that the accountant needs to at least compile the information because it normally is the minimum work that most accountants would want to perform on any supplementary information (client-prepared or otherwise) included in their report cover. In other words, they would at least "read" the client-prepared information for obvious errors and inconsistencies.

Supplementary Information Attached by the Client. The accountant's reporting responsibility for client-prepared supplementary information attached to the financial statements after they are delivered by the accountant is not directly addressed by SSARS. Realistically, the accountant has little control over the client's actions once he or she delivers the report. However, situations do occur when the client clearly communicates to the accountant that the financial statements will be combined with other client-prepared information and submitted by the client to third parties, e.g., to a bank as part of a loan proposal package. In fact, the accountant may accompany the client when he or she submits the package to the third party.

In these situations, the accountant may desire to add the following other-matter paragraph to his or her compilation or review report before the financial statements are 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 subjected to an audit, review, compilation, or preparation engagement by me (us) and, accordingly, I (we) do not express an opinion, a conclusion, or provide any assurance on it.

Are Percentages Presented on Financial Statements Supplementary Information?

In the authors' opinion, percentages presented in the financial statements (as is commonly the case with computer-prepared statements) do not constitute supplementary information for purposes of the reporting requirements of the SSARS. Accordingly, the accountant does not mention the percentages in his or her report. A related question is whether the inclusion of percentages implies the accountant has performed analytical procedures, and thus the engagement was a SSARS review engagement. The authors do not believe presentation of percentages requires the accountant to review the basic financial statements when he or she is engaged to compile such statements.

Is Pro Forma or Prospective Financial Information Presented with Historical Financial Statements Supplementary Information?

Generally, pro forma or prospective financial information would not be considered supplementary information. Accountants should follow the guidance in AR-C 120 when compiling pro forma financial information, and follow the guidance in AR-C 70 (AR-C 70A) or AR-C 80 (AR-C 80A), as applicable, when preparing or compiling prospective financial information. However, expired prospective information, such as an annual budget, presented for comparative purposes meets the definition of supplementary information discussed at the beginning of this section because it is no longer prospective in nature; therefore, AR-C 80.34–.36 (AR-C 80A.34–.36) and AR-C 90.126–.128 (AR-C 90A.83–.85) apply. In the authors' opinion, the expired supplementary budget information would not be reviewed, even when the historical financial statements are reviewed. This opinion is based on the assumption that the budget would not have been subjected to the inquiry and analytical procedures, if any, applied to the basic financial statements.

SSARS No. 22, *Compilation of Pro Forma Financial Information*, clarifies the requirements and guidance with respect to compilation of pro forma financial information. Pro forma financial information is discussed in detail in *PPC's Guide to Nontraditional Engagements*.

In addition, SSARS No. 23, *Omnibus Statement on Standards for Accounting and Review Services—2016*, expands the applicability of the SSARS for accountants that prepare or compile prospective financial information. Prospective financial information is discussed in detail in *PPC's Guide to Nontraditional Engagements*.

Supplementary Information Presented without Financial Statements

Because stand-alone supplementary information will ordinarily not constitute a financial statement, the accountant does not need to worry about complying with the SSARS for such information. However, the guidance provided in the section on other reporting situations later in this lesson can generally be followed if the accountant is asked to report on supplementary information that is to be presented without financial statements.

REQUIRED SUPPLEMENTARY INFORMATION

Required supplementary information is defined at AR-C 80.05 (AR-C 80A.05) and AR-C 90.08 (AR-C 90A.05) as any supplementary information that is required to be presented by a recognized accounting standards setting body. AR-C 80.A48 (AR-C 80A.A44) and AR-C 90.A201 (AR-C 90A.A145) provide the following examples of required supplementary information, both of which are discussed later in this lesson:

- Common interest realty associations (CIRA) information concerning future repairs and replacements of common property.
- Governmental entities budgetary comparison statements and management's discussion and analysis.

Common Interest Realty Associations

A CIRA is an association of real estate owners that is responsible for providing certain services and maintaining certain property that all the owners share or own in common. Two examples of CIRAs are homeowners' associations and condominium associations. FASB ASC 972-235-50-3 requires that CIRA financial statements include certain supplementary information related to estimated funding for future repairs and replacements of common property. The following paragraphs discuss required supplementary information and the accountant's responsibility in more detail.

Required Supplementary Information for CIRAs. FASB ASC 972-235-50-3 requires CIRAs to disclose the following supplementary information about future major repairs and replacements of its common property as supplementary information outside the basic financial statements as follows:

- Estimates of current or future costs of future major repairs and replacements of all existing components, such as roofs, including the following:
  - Estimated amounts required.
  - Methods used to determine the costs.
  - The basis for the calculations, including assumptions, if any, about interest and inflation rates.
  - Sources used.
  - Dates of studies made for that purpose, if any.
- A presentation of components to be repaired and replaced that includes the following:
  - Estimates of the remaining useful lives of the components.
  - Estimates of current or future replacement costs.
  - Amount of funds accumulated for each component to the extent designated by the CIRA's board of directors.

Unlike required supplementary information that is included with audited financial statements, compilation and review standards do not require accountants to apply any procedures to required supplementary information included with compiled or reviewed financial statements. AR-C 80.37–.39 (AR-C 80A.37–.39) and AR-C 90.129–.131 (AR-C 90A.86–.88), respectively, make clear that, under the SSARS, accountants have no responsibility to apply any procedures to the required supplementary information; that is, accountants are not required to compile or review the required supplementary information. Instead, they indicate in their report the degree of responsibility, if any, they are taking with respect to the supplementary information. The authors believe that many accountants will not subject the required supplementary information to compilation or review procedures because of the inherent subjectivity of the required supplementary information. In those circumstances, the following additional other-matter paragraph of the accountant's report on the financial statements would be appropriate:

> Accounting principles generally accepted in the United States of America require that information about future major repairs and replacements of common property on page [Page Number] through page [Page Number] be presented to supplement the basic financial statements. Such information, although not a required part of the basic financial statements, is required by the Financial Accounting Standards Board, who considers it to be an essential part of financial reporting and for placing the basic financial statements in an appropriate operational, economic, or historical context. Such information is the responsibility of management. I (We) have not audited, reviewed, or compiled the required supplementary information, and I (we) do not express an opinion, a conclusion, nor provide any assurance on it.

Nothing precludes accountants from compiling or reviewing the required supplementary information, however. In those circumstances—

- If accountants compile the required supplementary information, they follow the SSARS compilation performance and reporting guidance.
- If accountants review the required supplementary information, they follow the SSARS review performance and reporting requirements. (Generally, accountants would not review the supplementary information if the financial statements are only compiled.)
- If the CIRA does not present some of the required supplementary information, if the required supplementary information departs materially from prescribed guidelines, or if the accountant is unable to determine if the required supplementary information is in accordance with the prescribed guidelines, the accountant adds an other-matter paragraph to the compilation or review report on the basic financial statements stating that fact. See AR-C 80.38 (AR-C 80A.38) and AR-C 90.130 (AR-C 90A.87) for additional guidance on the wording of this paragraph.
- If all of the required supplementary information is excluded from the financial statements, the accountant adds an other-matter paragraph to the compilation or review report indicating that (a) management omitted the required supplementary information and (b) that missing information is required by the applicable accounting standard setter for placing the basic financial statements in an appropriate operational, economic, and historical context.

When accountants have compiled the basic financial statements and have compiled the required supplementary information, the following additional other-matter paragraph of the accountants' report on the financial statements would be appropriate:

> Accounting principles generally accepted in the United States of America require that information about future major repairs and replacements of common property on page [Page Number] through page [Page Number] be presented to supplement the basic financial statements. Such information, although not a required part of the basic financial statements, is required by the Financial Accounting Standards Board, who considers it to be an essential part of financial reporting and for placing the basic financial statements in an appropriate operational, economic, or historical context. Such information is the responsibility of management. The required supplementary information was subject to my (our) compilation engagement. I (We) have not audited or reviewed the required supplementary information and, accordingly, do not express an opinion, conclusion, nor provide any assurance on such information.

If the accountants become aware that the required supplementary information is not measured or presented in conformity with the applicable financial reporting framework, AR-C 80.38 (AR-C 80A.38) states that the accountant should modify his or her compilation report on the required supplementary information with a paragraph such as:

> Accounting principles generally accepted in the United States of America require that information about future major repairs and replacements of common property on page [Page Number] through page [Page Number] be presented to supplement the basic financial statements. Such information, although not a required part of the basic financial statements, is required by the Financial Accounting Standards Board, who considers it to be an essential part of financial reporting and for placing the basic financial statements in an appropriate operational, economic, or historical context. Such information is the responsibility of management. The required supplementary information was subject to my (our) compilation engagement. I (We) have not audited or reviewed the required supplementary information and do not express an opinion, a conclusion, nor provide any assurance on such information. The required supplementary information materially departs from the requirements of the Financial Accounting Standards Board. [Describe the material departures from the applicable financial reporting framework.]

If the CIRA omits the required supplementary information (including its omission from compiled financial statements that omit substantially all disclosures required by GAAP and a statement of cash flows), AR-C 80.39 (AR-C 80A.39)

and AR-C 90.131 (AR-C 90A.88) state that the accountants' report should describe the omission in an additional paragraph of their report on the basic financial statements, such as the following:

> Management has omitted supplementary information about future major repairs and replacements of common property that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by the Financial Accounting Standards Board, who considers it to be an essential part of financial reporting and for placing the basic financial statements in an appropriate operational, economic, or historical context.

Accountants need not present the required supplementary information if the CIRA omits it.

Reviewing Required Supplementary Information. As discussed above, nothing precludes accountants from reviewing required supplementary information. However, for the following reasons, the authors recommend against performing reviews of the required supplementary information:

- Unless specifically engaged to do so, auditors give no assurance when reporting on required supplementary information included with audited basic financial statements. Therefore, the authors believe that it would be confusing and inappropriate for accountants to give a higher level of assurance on such information accompanying compiled or reviewed financial statements.
- In addition, it is doubtful that the review procedures applied to the financial statements would be sufficient to allow the accountants to express review assurance on the supplementary information because those inquiries and analytical procedures would not be directed to the estimated future costs of future major repair or replacement of the common property components.

CONSIDERATIONS FOR REPORTING ON CHARTS AND GRAPHS

Equipped with computers capable of converting financial information to graphic presentations with the push of a button, many accountants have traded traditional numerical presentations for bar graphs and pie charts that depict a wide variety of supplementary information useful to their clients. Common examples include charts or graphs depicting the following:

- Number of days sales in accounts receivable
- Sales by product line
- Operating expenses by plant
- Line of credit usage versus owned inventory

With those innovations, however, come questions regarding accountants' reporting responsibilities for graphic presentations since there are no authoritative standards that specifically address them. This section discusses the authors' views on the issue.

Charts and Graphs That Accompany Financial Statements

When the basic financial statements are accompanied by information in the form of a chart or graph, the authors believe that such information would be considered supplementary information. Accordingly, accountants should follow the earlier guidance on reporting on supplementary information to determine how to report on them. The following are some specific issues to be considered:

- Consistency if the same information is presented numerically in the basic financial statements and graphically in supplementary information.
- Whether the information is presented in a way that is obviously misleading.
- Whether to include a reference to the accountant's report on each chart or graph.

Due to the subjective nature of graphic presentations, the authors believe that accountants will ordinarily elect not to report on them as reviewed when they accompany reviewed financial statements.

Stand-alone Charts and Graphs

Some accountants may wish to include reports indicating the degree of responsibility, if any, they are taking with respect to stand-alone charts and graphs. In that case, the reporting decision is based on what type of information is presented. For example, a graph that portrays the sources of working capital for the past three years might be considered a presentation of specified elements of a financial statement. Another example is a graph depicting net sales, gross margins, and income for the past five years, which might be considered a presentation of condensed financial information.

SELF-STUDY QUIZ

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

9. Which of the following statements best describes an issue related to compilation or review reports?

    a. It is a best practice not to mention a lack of independence in a compilation report.

    b. Financial statements that omit substantially all disclosures can be reviewed by an accountant if the omission is disclosed.

    c. Omitting the statement of cash flows is a departure from the reporting framework and must be mentioned in the report.

    d. When a scope limitation is encountered, the accountant should issue an except for opinion or a disclaimer of opinion.

10. Angelina is engaged to perform a compilation engagement. During the course of her engagement, Angelina becomes aware of material measurement departures from GAAP. Which of the following would be the preferred course of action?

    a. She should include the correct information in her report.

    b. She should withdraw from the engagement immediately.

    c. She should ask the client to revise the statements to conform with GAAP.

    d. She should refer to the GAAP departure in her compilation report.

11. Which of the following would be included in an other matter paragraph of a review report if the accountant reviewed supplementary information presented with the client's financial statements, but would be excluded if the supplementary information had not been reviewed?

    a. A heading, such as *Other Matter* or *Supplementary Information*.

    b. A statement that the supplementary information was presented for additional analysis purposes only.

    c. A statement that the supplementary information is management's responsibility.

    d. A statement that the supplementary information was subjected to review procedures.

12. Ron is engaged to review a common interest realty association (CIRA). His CIRA client presents required supplementary information. Which of the following guidance applies in this situation?

    a. Ron is precluded from reviewing the required supplementary information and must compile it instead.

    b. If the required supplementary information has material departures from the prescribed guidelines, Ron must withdraw from the review engagement.

    c. If his client excluded all of the required supplementary information from the financial statements, Ron should add an other-matter paragraph to his report.

    d. Ron should follow SSARS compilation performance and reporting guidance when working on the required supplementary information.

SELF-STUDY ANSWERS

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

9. Which of the following statements best describes an issue related to compilation or review reports? **(Page 199)**

    a. It is a best practice not to mention a lack of independence in a compilation report. [This answer is incorrect. The accountant's compilation report *should* specifically disclose any lack of independence, per AR-C 80.22 (AR-C 80A.22).]

    b. Financial statements that omit substantially all disclosures can be reviewed by an accountant if the omission is disclosed. [This answer is incorrect. Financial statements that omit substantially all disclosures may be *compiled* by the accountant (not reviewed) provided the accountant's report discloses the omission, and the omission, in the accountant's professional judgment, would not mislead those who might reasonably be expected to use the financial statements.]

    c. **Omitting the statement of cash flows is a departure from the reporting framework and must be mentioned in the report. [This answer is correct. According to FASB ASC 230-10, when a business enterprise or nonprofit organization presents both a balance sheet and a statement of operations (income statement), a statement of cash flows should also be presented as a basic financial statement. A statement of cash flows should be presented for each period for which an income statement is presented. Thus, omitting the statement of cash flows constitutes a departure from the applicable financial reporting framework. Like other departures from the applicable financial reporting framework, the accountant discloses the departure in a separate paragraph of his or her report.]**

    d. When a scope limitation is encountered, the accountant should issue an except for opinion or a disclaimer of opinion. [This answer is incorrect. When an *auditor* encounters a scope limitation, he or she issues either an *except for* opinion or a disclaimer of opinion. However, the SSARS do not permit such reporting, so this is not allowed in a review or compilation engagement.]

10. Angelina is engaged to perform a compilation engagement. During the course of her engagement, Angelina becomes aware of material measurement departures from GAAP. Which of the following would be the preferred course of action? **(Page 201)**

    a. She should include the correct information in her report. [This answer is incorrect. The omission of any material *disclosures* from reviewed financial statements is considered a GAAP departure. In these instances, the accountant includes in the review report the omitted disclosures or, if the details to be disclosed have not been determined, the specific nature of the omitted disclosures. However, the omission of material disclosures is a different consideration than material measurement departures. Also, Angelina is performing a compilation engagement not a review engagement. Therefore, this answer choice does not apply in Angelina's situation.]

    b. She should withdraw from the engagement immediately. [This answer is incorrect. Withdrawing from the engagement is one course of action Angelina can take in this situation; however, there are other courses of action she should attempt before withdrawing. If Angelina does withdraw, she should consider consulting legal counsel.]

    c. **She should ask the client to revise the statements to conform with GAAP. [This answer is correct. If, in the course of a compilation or review engagement, the accountant becomes aware of material measurement departures from GAAP, he or she has several possible courses of action. Persuading the client to revise the statements to conform with GAAP is the preferred course of action. Therefore, this is the avenue Angelina should pursue if at all possible. If not, she can take one of the other courses of action described in the SSARS.]**

d. She should refer to the GAAP departure in her compilation report. [This answer is incorrect. Referring to the departure in her report is one action Angelina can take under the SSARS in these circumstances. However, it is not the preferred action. If the preferred action is not feasible, then reporting the departure in the accountant's report is appropriate unless Angelina concludes that reporting the departure would mislead the reader.]

11. Which of the following would be included in an other matter paragraph of a review report if the accountant reviewed supplementary information presented with the client's financial statements, but would be excluded if the supplementary information had not been reviewed? **(Page 205)**

    a. A heading, such as *Other Matter* or *Supplementary Information*. [This answer is incorrect. A heading titled *Other Matter* or another appropriate heading such as *Supplementary Information* is required both when the accountant reviewed the supplementary information and when that information was not reviewed.]

    b. A statement that the supplementary information was presented for additional analysis purposes only. [This answer is incorrect. Whether the supplementary information was reviewed by the accountant or not, the other matter paragraph should state that the supplementary information is presented only for additional analysis purposes and is not a required part of the financial statements.]

    c. A statement that the supplementary information is management's responsibility. [This answer is incorrect. Whether the accountant reviewed the supplementary information or not, the other matter paragraph should say that the supplementary information is the responsibility of management. If the accountant reviewed the supplementary information, he or she should also add that such information was derived from, and relates directly to, the underlying records (accounting or other) used to prepare the financial statements.]

    d. **A statement that the supplementary information was subjected to review procedures. [This answer is correct. AR-C 90.126–.128 (AR-C 90A.83–.85) require 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 in a separate report on the supplementary information. When the accountant has reviewed such information, the other-matter paragraph or the separate report should include several specific items, some of which would also be included if the supplementary information had not been reviewed. If the information was reviewed, however, the paragraph (or separate report) should state that 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 in order for it to be in conformity with the applicable financial reporting framework.]**

12. Ron is engaged to review a common interest realty association (CIRA). His CIRA client presents required supplementary information. Which of the following guidance applies in this situation? **(Page 208)**

    a. Ron is precluded from reviewing the required supplementary information and must compile it instead. [This answer is incorrect. Nothing precludes accountants from compiling or reviewing the required supplementary information. Therefore, Ron can review his CIRA client's required supplementary information in addition to reviewing its financial statements.]

    b. If the required supplementary information has material departures from the prescribed guidelines, Ron must withdraw from the review engagement. [This answer is incorrect. If the CIRA does not present some of the required supplementary information, if the required supplementary information departs materially from prescribed guidelines, or if the accountant is unable to determine if the required supplementary information is in accordance with the prescribed guidelines, the accountant adds an other-matter paragraph to the compilation or review report on the basic financial statements stating that fact. Therefore, Ron would not need to withdraw from the engagement under these circumstances.]

c. **If his client excluded all of the required supplementary information from the financial statements, Ron should add an other-matter paragraph to his report. [This answer is correct. If all of the required supplementary information is excluded from the financial statements, the accountant adds an other-matter paragraph to the compilation or review report indicating that (1) management omitted the required supplementary information and (2) the missing information is required by the applicable accounting standards setter for placing the basic financial statements in an appropriate operational, economic, and historical context. Therefore, Ron's other-matter paragraph should be sufficient.]**

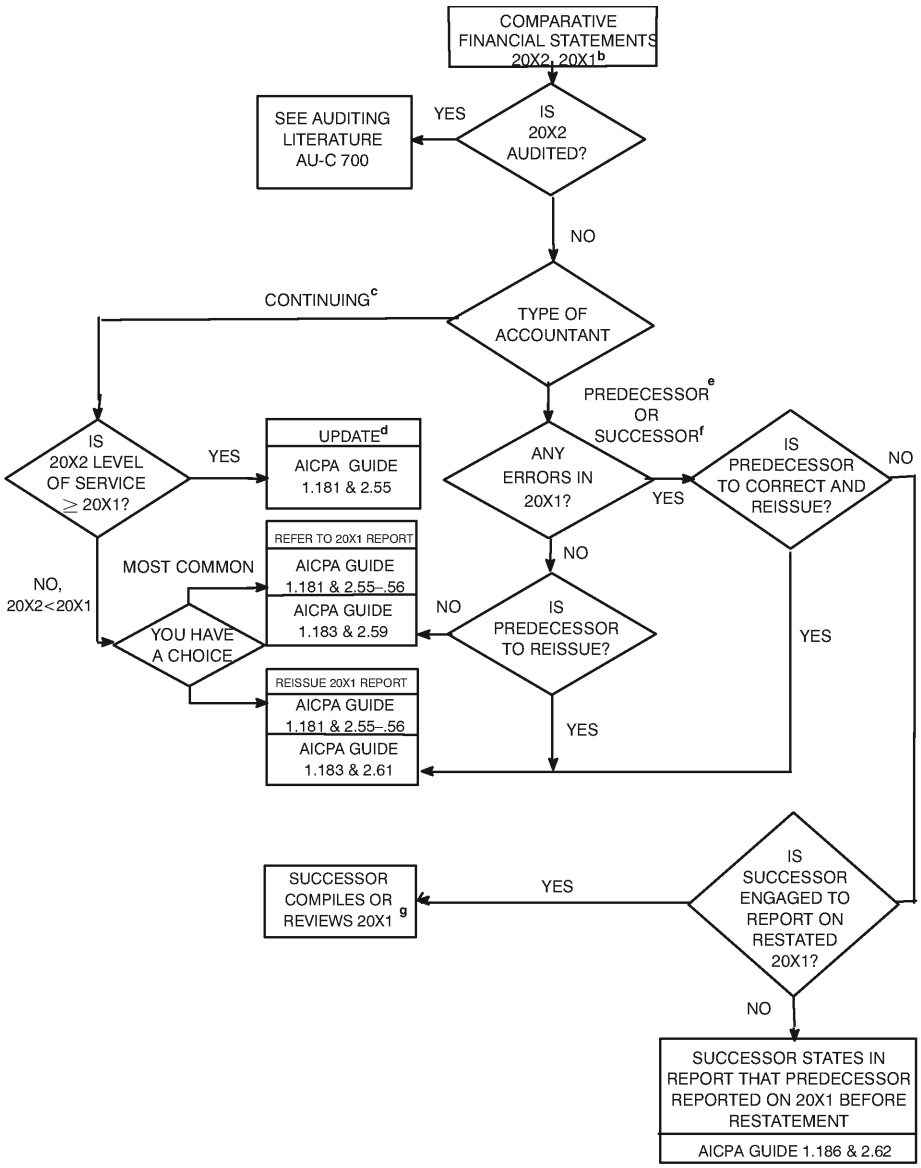
d. Ron should follow SSARS compilation performance and reporting guidance when working on the required supplementary information. [This answer is incorrect. If Ron were compiling the required supplementary information, then he would use this guidance. Since he is reviewing the required supplementary information, Ron should follow the SSARS review performance and reporting requirements. Generally, accountants would not review the supplementary information if the financial statements are only compiled.]

REPORTING ON AN ENTITY'S COMPARATIVE FINANCIAL STATEMENTS

When financial statements of two or more periods are presented in columnar form, the accountant reports on each period presented. The accountant's report in such a situation is relatively simple to draft if certain changes have not occurred. However, situations do change, e.g., clients change accountants, clients request different levels of service, clients change their status as an issuer or a nonpublic entity, additional information regarding previously issued financial statements becomes available, and new financial reporting standards evolve. Each of these changes can complicate the accountant's report on comparative financial statements. The following paragraphs discuss the standard comparative reports and variations necessary because of the changes mentioned previously. Exhibit 2-1 presents a flowchart detailing the considerations in reporting on comparative financial statements of nonpublic companies.

Exhibit 2-1

Reporting on Comparative Financial Statements of Nonpublic Companies[a]



Notes:

[a] All references to the AICPA Guide are to the June 15, 2020, version of the AICPA Guide: *Preparation, Compilation, and Review Engagements*.

[b] If the 20X1 financial statements have not been audited, reviewed, or compiled, the accountant reviewing or compiling the 20X2 financial statements may advise the client to clearly indicate this fact on the 20X1 financial statements. (AICPA Guide 2.52)

[c] If the continuing accountant performed a compilation (or a review) on the 20X1 financial statements and is engaged to prepare the financial statements in 20X2, the continuing accountant is not required to, but may, reissue the 20X1 compilation (or review) report. (AICPA Guide 2.53)

[d] If the report on the 20X1 financial statements contains a changed reference to a departure from the financial reporting framework, the 20X2 review report should include an other-matter paragraph (AICPA Guide 1.184) or the 20X2 compilation report may include an explanatory paragraph. (AICPA Guide 2.58)

[e] The predecessor accountant is not required to, but may, reissue the 20X1 report. (AICPA Guide 1.183 and 2.59)

[f] When the predecessor does not reissue the 20X1 report, the successor accountant who has compiled the 20X2 financial statements is not required to make reference to a prior auditor's or accountant's audit, compilation, or review report, but is not precluded from doing that in an additional or other-matter paragraph. (AICPA Guide 1.183 and 2.60) However, when the successor accountant has reviewed the 20X2 financial statements and the predecessor has not reissued the audit report, the successor accountant is required to make reference. (AICPA Guide 1.185)

[g] If the successor accountant is also engaged to review or compile a restatement adjustment, that may be stated in the accountant's report. (AICPA Guide 1.186 and 2.63)

Standard Reports

Provided none of the changes discussed in the previous paragraph take place for any of the periods presented, the accountant's report on comparative financial statements has a few differences from a single period report. For comparative financial statements, each period presented in the comparative financial statements should be identified. Additionally, in the accountant's report, certain terms would be plural. The accountant is, as of the date of the current report, *updating* his or her report on the financial statements of the prior period.

According to AR-C 90.84–.85 (AR-C 90A.47–.48), when updating the report, the continuing accountant takes into consideration information that he or she becomes aware of during his or her current engagement and, if during the current engagement circumstances or events come to the accountant's attention that may have led to different conclusions on the financial statements of a prior period, the accountant should consider the effects on the accountant's report. If, because of additional information now available to him or her, the accountant cannot re-express his or her previous conclusions, refer to the "Change in Prior-period Financial Statements—Continuing Accountant" discussion later in this section.

The following is an example of the standard compilation report on comparative financial statements:

> Management is responsible for the accompanying financial statements of XYZ Company (a corporation), which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income and retained earnings and cash flows for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. I (We) have performed the compilation engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (We) did not audit or review the financial statements nor was I (were we) required to perform any procedures to verify the accuracy

> or completeness of the information provided by management. I (we) do not express an opinion, a conclusion, nor provide any assurance on these financial statements.

The introductory paragraph of a standard review report on comparative financial statements is as follows:

> I (We) have reviewed the accompanying financial statements of XYZ Company (a corporation), which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income and retained earnings and cash flows for the years then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's financial data and making inquiries of company management. 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. Accordingly, I (we) do not express such an opinion.

Titling Accountant's Reports on Comparative Financial Statements

AR-C 80 (AR-C 80A) does not include a requirement that the accountant's compilation report include a title. However, AR-C 90 (AR-C 90A) does include a requirement that the accountant's review report include a title with the word *Independent*. AR-C 90.A110 (AR-C 90A.A69) states that an appropriate title for a review report would be "Independent Accountant's Review Report." If the accountant is engaged to report on comparative financial statements with the same level of service (i.e., both years reviewed), then those suggested titles would still be appropriate. The question arises about how to title the accountant's report when there is a change in the level of service (i.e., current year reviewed and prior year compiled). The authors believe that a generic title such as "Independent Accountant's Report" may be used so that the title does not indicate the level of service, thus not confusing the reader about the level of service.

Change in Level of Service—Current Period Reviewed/Prior Period Compiled

The updating of the prior period report that is required when the level of service is the *same* for both periods is also required when the level of service is *higher* for the current period, i.e., 20X2 reviewed/20X1 compiled. As noted above, updating the report means that the accountant is issuing his or her report on the prior period as of a new (updated) date. The accountant should then reconsider his or her original conclusions based on any new information available [AR-C 90.84 (AR-C 90A.47)].

Because the report language is different for review and compilation reports, the accountant cannot update his or her report simply by presenting all periods reported on in the report, as is the case when the level of service is the same for each period. When the accountant provides a higher level of service in the current period, he or she updates the report on the prior period by following the last paragraph of the review report on the current period with a paragraph summarizing the report on the prior period compiled statements.

Change in Level of Service—Current Period Compiled/Prior Period Reviewed

When the level of service for the current year is lower than the prior period, i.e., 20X2 compiled/20X1 reviewed, the accountant does not need to *update* his or her report on the prior period. However, he or she would (a) refer to the original review report in the compilation report on the current period, including the original date of the report, and state that he or she has not performed any procedures in connection with the review since that date *or* (b) reissue the review report on the financial statements of the prior period.

The first alternative (referring in the current period compilation report to the original review report on the prior year) can be accomplished by adding to the compilation report a paragraph as follows from Paragraph 2.102, Illustration 12, of the AICPA Guide:

> The accompanying 20X1 financial statements of XYZ Company were previously reviewed by me (us) and I (we) stated that I was (we were) not aware of any material modifications that should be made to those financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America in my (our) report dated March 1, 20X2, but I (we) have not performed any procedures in connection with that review engagement since that date.

The second alternative is to reissue the prior year report. The primary difference between a reissued report and an updated report is the date of the report. An *updated report* bears a new date; a reissued report bears the original date. (See discussion of dual-dating later in this section.) An *updated report* is appropriate when the accountant has performed sufficient procedures subsequent to the original date to allow him or her to offer the same level of assurance at the later date. Thus, an updated compilation report of a prior period can be presented with a review report of a current period. The compilation report offers no assurance and thus can be issued at the later date if the accountant takes into consideration any information that he or she becomes aware of during the current engagement.

A reissued report is appropriate when a lower level of service is provided in the subsequent period. For example, when a review report for the prior period is presented in comparative format with current period financial statements that are compiled, a reissued report is appropriate.

Reissuing the prior period review report can be done by (a) creating one report in which the reissued prior period report is simply tacked on to the end of the current period compilation report or (b) presenting the two reports separately.

Change in Level of Service—Current Period Compiled or Reviewed/Prior Period Audited

If current period compiled or reviewed financial statements are presented in comparative form with prior period audited statements, the accountant's reporting obligation is similar to that required when compiled financial statements of the current period are presented with reviewed statements of the prior period. Both situations represent a change to a lower level of service and thus require either (a) reissuance of the prior period report or (b) reference to the prior period report in a separate paragraph of the current period report. The mechanics of reissuing a prior period review report which is equally applicable to reissuing a prior period audit report were discussed above.

The second alternative, reference to the prior period report, is generally the most practical and is done by adding a separate other-matter paragraph at the end of the compilation or review report on the current period financial statements. AR-C 90.87 (AR-C 90A.50) requires that the separate paragraph of the report indicate (a) that the financial statements were audited previously, (b) the date of the previous report, (c) the type of opinion expressed previously, (d) if the opinion was modified, the substantive reasons therefore, and (e) that no auditing procedures were performed after the date of the previous report. An example of such a separate paragraph is the following based on Paragraph 1.241, Illustration 14, of the AICPA Guide:

> The 20X1 financial statements were audited by me (us) (other accountants) and I (we) (they) expressed an unmodified opinion on them in my (our) (their) report dated March 1, 20X2. I (We) (They) have not performed any auditing procedures since that date.

Change in Level of Service—Disclosures Omitted

Financial statements that omit substantially all disclosures, i.e., certain compiled financial statements, are not comparable to financial statements that include such disclosures. The requirements set forth in AR-C 80.26 (AR-C 80A.26) allow substantially all disclosures to be omitted only for compiled financial statements. *Thus, comparative financial statements that omit substantially all disclosures can be reported on by a CPA only when all periods presented have been compiled*.

Paragraph 2.54 of the AICPA Guide makes it clear that comparative financial statements are not appropriate if some, but not all, periods omit substantially all disclosures. In those instances, to report on the statements in comparative form, the accountant needs to either:

a. upgrade the level of service to include all disclosures for all periods, or

b. lower the level of service to omit all disclosures for all periods.

Change of Accountants—General

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.

Change of Accountants—Predecessor Accountant Reissues His Report

A predecessor accountant is not required to reissue his report when the statements he or she reported on are included in comparative financial statements. However, if the accountant does so, the authors believe he or she needs to consider whether his or her report is still appropriate. AR-C 80 (AR-C 80A), AR-C 90 (AR-C 90A), and the AICPA Guide are silent on what considerations the predecessor would make in determining whether the report is still appropriate. The authors believe that in making this determination, consideration is given to: (a) the current form and manner of presentation of the prior period financial statements, (b) subsequent events not previously known, and (c) changes in the financial statements that require the addition or deletion of modifications to the standard report.

Before reissuing his or her compilation or review report on the financial statements of a prior period, the predecessor may decide to perform procedures such as the following:

a. Read the financial statements of the current period and the successor's report.

b. Compare the prior period financial statements with those previously issued and with those of the current period.

c. Obtain a letter from the successor that indicates whether the successor is aware of any matter that, in the successor's opinion, might have a material effect on the financial statements, including disclosures, reported on by the predecessor. The predecessor would not refer in his or her reissued report to this letter or to the report of the successor.

A reissued report typically bears the date of the original report. However, if the prior year financial statements are changed because of additional information the predecessor obtains, the predecessor would ordinarily dual-date his or her report. Dual-dating is discussed later in this section.

Change of Accountants—Reference Made to Predecessor Accountant's Report

If the current accountant chooses to refer in his or her report on comparative financial statements to the report of the predecessor accountant, the accountant would do so by adding one or more other-matter paragraphs to his or her report on the current period financial statements. Based on paragraphs 1.183 and 2.59–2.60 of the AICPA Guide, the other-matter paragraph, should include—

a. A statement that the financial statements of the prior period were compiled or reviewed by another accountant (other accountants).

b. The date of his (their) report.

c. A description of the accountant's report, as applicable.

   (1) When the prior year financial statements were compiled, that description would be a statement that the other accountant(s) did not audit or review the financial statements and, accordingly, did not express an opinion or provide any assurance about whether the prior period financial statements are in accordance with the applicable financial reporting framework.

(2) When the prior year financial statements were reviewed, that description would be a statement that the other accountant(s), based on his (their) review was (were) not aware of any material modifications that should be made to the financial statements in order for them to be in accordance with the applicable financial reporting framework, other than any modifications indicated in the report.

d. A description or a quotation of any modifications of the standard report and of any paragraphs emphasizing a matter regarding the financial statements.

The Reference to the Predecessor Accountant's Report Should Not Include the Name of the Predecessor Accountant

The following illustrate how the reference to the predecessor accountant's report might read when the predecessor issued a standard report.

a. When the predecessor reviewed the financial statements of the prior period, an example of the wording in the successor's report is as follows based on Paragraph 1.241, Illustration 16, of the AICPA Guide:

> The financial statements of XYZ Company as of December 31, 20X1, were reviewed by other accountants whose report dated March 1, 20X2, stated that based on their procedures, they are not aware of any material modifications that should be made to those financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

b. When the predecessor compiled the financial statements of the prior period, an example of the wording in the successor's report is as follows based on Paragraph 2.102, Illustration 14, of the AICPA Guide:

> The financial statements of XYZ Company as of December 31, 20X1, were subjected to a compilation engagement by other accountants whose report dated February 1, 20X2, stated that they have not audited or reviewed the 20X1 financial statements and, accordingly, do not express an opinion, a conclusion, nor provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

The authors suggest the following reference when the predecessor issued a modified report:

> The financial statements of XYZ Company as of December 31, 20X1, were reviewed by other accountants whose report dated March 1, 20X2, stated that based on their procedures, they are not aware of any material modifications that should be made to those financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America, with the exception of the matter described in the following paragraph.
>
> A statement of cash flows for the year ended 20X1 has not been presented. Accounting principles generally accepted in the United States of America require that such a statement be presented when financial statements purport to present financial position and results of operations.

Change of Accountants—Successor Accountant Compiles, Reviews, or Audits Prior-period Financial Statements

If the successor accountant decides to compile or review the prior period financial statements, he or she does so in accordance with AR-C 80 (AR-C 80A) or AR-C 90 (AR-C 90A), respectively, and his or her reporting obligation becomes the same as that of a continuing accountant. If he or she audits the prior period financial statements, he or she should refer to auditing literature. In either case, he or she would make *no* reference in his or her report to the predecessor's previously issued report.

Change of Accountants—Reporting Following a Merger or Purchase of an Accounting Firm

When there has been a merger or purchase of a firm, the new firm or purchaser may report as a successor accountant and apply the guidance in AR-C 90.A134 (AR-C 90A.A88). Basically, it permits the successor to (a) make reference to the old or acquired firm's report or (b) assume compilation, review, or audit responsibility for the prior period financial statements. The new firm or purchaser may also indicate in the report or as a part of the signature that a merger or purchase took place and may name the firm with whom it was merged.

Change of Accountants—Predecessor Accountant Has Ceased Operations

A problem that is becoming more prevalent deals with the effect on a successor accountant's report on comparative financial statements when a predecessor accountant, who has compiled or reviewed the client's prior-period financial statements, has ceased operations. The answer depends on whether the prior-period financial statements have been restated.

If the prior-period financial statements were *compiled* or *reviewed* and *have not been restated*, the authors believe that the successor accountant would add a paragraph to the report on the current-year financial statements that includes:

a. A statement that the prior-period financial statements were compiled or reviewed by another accountant who has ceased operations.

b. The date of the predecessor accountant's report.

c. A description of the standard form of disclaimer or limited assurance, as applicable, included in the report.

d. A description or quotation of any modifications of the standard report and any paragraphs emphasizing a matter regarding the financial statements.

These are the same requirements when reference is made to any predecessor accountant's report. The only difference is the notation that the predecessor accountant has ceased operations.

If the prior-period financial statements were *audited* and *have not been restated*, the successor accountant would add a paragraph to the report on the current-period financial statement that indicates (a) that the prior-period financial statements were audited by another accountant who has ceased operations, (b) the date of the predecessor auditor's report, (c) the type of opinion issued by the predecessor, (d) if the opinion was other than unqualified, the substantive reasons therefor, and (e) that no auditing procedures were performed after the date of the predecessor's report. Reference to the predecessor would not include the name of the predecessor.

If the prior-period financial statements *have been restated*, the successor accountant would compile, review, or audit those financial statements or the restatement adjustment(s) and report accordingly. In addition, the successor is required to ensure that certain matters are communicated by management to the party responsible for winding up the affairs of the predecessor accountant.

Change of Accountants—What Is the Best Option?

The successor's options include (a) attempt to have the previous accountant reissue his or her report, (b) make reference in his or her report to the previous accountant's report, or (c) extend his or her services to include a compilation, review, or audit of the prior period financial statements. Here are a few observations by the authors:

a. Reference to the predecessor accountant's report is generally the simplest and least costly approach for the client.

b. In many cases, the successor accountant may want to reformat the prior period statements. A reformatting that does not affect caption totals in the previous financial statements, e.g., reordering of the presentation of items under a major caption or a change to a more descriptive caption, would not prevent the successor from referring to the predecessor's report. However, a restatement of the prior period financial statements (such as the correction of a measurement, classification, or disclosure error) would require that:

(1) the predecessor accountant reissue his or her report,

(2) the successor accountant report on the financial statements for both years, or

(3) the successor accountant report on the restatement adjustment.

Reference to the previous report would not be acceptable in the first two options. Reference to the previous report with modification would be appropriate if the third option is chosen. All three options would require additional compilation or review procedures. Generally, the procedures required for the successor accountant to report on the financial statements for both years would be the most costly option. And the procedures required for the successor accountant to report on the restatement adjustment would generally be the least costly of the three options.

c. There can, however, be some practical problems in working with a predecessor accountant. Who does the predecessor accountant bill: the successor accountant or a client who perhaps fired the predecessor? How are differences in professional judgment resolved, e.g., what happens if the successor accountant thinks the prior period financial statements should be restated and the predecessor disagrees? Also note that review of the successor accountant's workpapers by the predecessor is suggested in certain situations.

Change of Status—Issuer to Nonpublic Entity

If the current status of the entity is a nonpublic entity, the accountant would follow the guidance provided by SSARS, even if the entity was an issuer for the prior periods presented. If the prior period statements were for an issuer, they were either audited statements or unaudited statements. If they were audited, the accountant should refer to the "Change in Level of Service—Current Period Compiled or Reviewed/Prior Period Audited" discussion earlier in this section. If the prior period statements were unaudited, the accountant should comply with the compilation or review standards in AR-C 80 (AR-C 80A) or AR-C 90 (AR-C 90A), respectively, or the interim review standards in AU-C 930, if applicable.

The authors believe the status of the entity is determined at the balance sheet date. Thus, the status at the end of the current period is controlling regardless of the status during the current period. For example, an entity that goes public on June 30, 20X1, is considered an issuer with regard to financial statements for the year ended December 31, 20X1.

Change of Status—Nonpublic Entity to Issuer

SSARS is not the appropriate source of guidance for comparative financial statements when the status of the entity is an issuer as of the current balance sheet date. If the entity is an issuer on the balance sheet date of the current period, it is inappropriate to reissue or make reference to the accountant's prior period compilation or review report in the report on the financial statements of the current period. Thus, the accountant must issue a new report on the prior period financial statements in accordance with PCAOB standards.

Change in Prior-period Financial Statements—General

In the process of compiling or reviewing financial statements for the current period, an accountant may determine that, in his or her judgment, the prior period financial statements should be restated. The accountant could arrive at this determination because of mathematical or clerical errors, misapplication of the applicable financial reporting framework (including inadequate disclosures), or because of facts existing at the date of the accountant's report on the prior period that he or she becomes aware of during the current engagement.

Change in Prior-period Financial Statements—Continuing Accountant

If the accountant is a continuing accountant, he should restate the financial statements and/or alter his or her report. If the accountant is *reissuing* the prior period report, i.e., level of service was higher for the prior period than for the current period, the accountant generally should date the report as discussed below. If the level of service is the same or higher in the current period, the report on the prior period would be updated, i.e., use the same date as for the report on the current period.

Regardless of a change in level of service, when a reference to a departure from the applicable financial reporting framework in the continuing accountant's original report on the prior period financial statements is changed, AR-C 90.86 (AR-C 90A.49) requires that the reissued or updated report include a separate other-matter paragraph indicating—

a. The date of the accountant's previous report.

b. The circumstances or events that caused the reference to be changed.

c. When applicable, that the financial statements of the prior period have been changed.

The following is an example of an other-matter paragraph that is appropriate when an accountant's compilation report contains a changed reference to a departure from the applicable financial reporting framework based on Paragraph 2.102, Illustration 13, of the AICPA Guide:

> In my (our) report dated March 1, 20X2, with respect to the 20X1 financial statements, I (we) referred to a departure from accounting principles generally accepted in the United States of America because the Company carried its land at appraised values. As described in Note X, the Company has changed its method of accounting for land and restated its 20X1 financial statements to be in accordance with accounting principles generally accepted in the United States of America.

The following is an example of an other-matter paragraph that is appropriate when an accountant's review report contains a changed reference to a departure from GAAP based on Paragraph 1.241, Illustration 15, of the AICPA Guide:

> In my (our) review report dated March 1, 20X2, with respect to the 20X1 financial statements, I (we) referred to a departure from accounting principles generally accepted in the United States of America because the Company carried its land at appraised values. As described in Note X, the Company has changed its method of accounting for land and restated its 20X1 financial statements to be in accordance with accounting principles generally accepted in the United States of America. Accordingly, my (our) present statement on the 20X1 financial statements, as presented herein, that I am (we are) not aware of any material modifications that should be made to the accompanying financial statements is different from that expressed in my (our) previous report.

If the change in the prior-period financial statements does not result in a changed reference to a departure from GAAP, the accountant is not required to include the separate other-matter paragraph in the report. However, the accountant may choose to add the other-matter paragraph in order to draw the users' attention to the matter. The following is an example of an other-matter paragraph that is appropriate to include in the compilation report on comparative financial statements when prior-period financial statements have been restated, and the change does not result in a changed reference to a departure from GAAP:

> As discussed in Note X to the financial statements, the 20X1 financial statements have been restated to correct a misstatement.

The following is an example of an other-matter paragraph that is appropriate to include in the review report on comparative financial statements when prior-period financial statements have been restated, and the change does not result in a changed reference to a departure from GAAP:

> As discussed in Note X to the financial statements, the 20X1 financial statements have been restated to correct a misstatement. My (Our) conclusion is not modified with respect to this matter.

Restated Prior-period Financial Statements—Successor Accountant

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) —

a. the predecessor accountant reissues his or her report,

b. the successor accountant reports on the financial statements for both years, or

c. the successor accountant reports on the restatement adjustment.

If the predecessor accepts the reporting obligation and reissues his or her report on the restated financial statements, the predecessor would perform the procedures listed in the "Change of Accountants—Predecessor Accountant Reissues His Report" paragraphs earlier in this section. In those circumstances, the predecessor dual-dates the reissued report. If the successor is to report on the restated financial statements, the successor performs a compilation or review in accordance with AR-C 80 (AR-C 80A) or AR-C 90 (AR-C 90A), 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.

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.

Obviously, the successor needs to weigh the advantages and disadvantages of each of the options before determining whether to attempt to have the predecessor reissue his or her report or to expand the engagement to include services with respect to the prior period financial statements.

Dual Dating

AR-C 90.52 (AR-C 90A.73) states that a reissued report may need to be revised for the effect of specific events but provides no guidance regarding which events require revision. Accounting and auditing literature, however, indicate that the following circumstances generally require revision of a previously issued report or a modification of the financial statements of the prior period:

a. The correction of an error in previously issued financial statements. The correction of an error includes a change from an accounting principle that is not generally accepted to one that is.

b. A material "recognized" subsequent event that occurs between the original issuance of the accountant's report and the reissuance of the financial statements. Note, however, that FASB ASC 855-10-25-4 states that financial statements should not be adjusted for events occurring between the original issuance and the reissuance of the financial statements unless the adjustment is required by GAAP or regulatory requirements. However, the events may require disclosure in the reissued financial statements to keep them from being misleading.

c. The change to an accounting principle (including a change necessitated by the issuance of a new authoritative accounting pronouncement) that requires retrospective application.

d. Other prior period adjustments meeting the criteria in FASB ASC 250-10-45-25 and 45-26; 270-10-45-17 and 45-18.

In most circumstances, if prior period financial statements are restated or the predecessor accountant revises his or her report, the predecessor would dual-date his or her reissued report with the original date and a separate date for the event, transaction, or circumstance that caused the change. For example, if a material "recognized" subsequent event occurs between the original issuance and the reissuance of the financial statements, the event would be disclosed in the financial statements. In such circumstances, the predecessor accountant's report ordinarily is dated as follows: March 1, 20X2 (the original report date), except for Note X, as to which the date is April 1, 20X2 (the date of the subsequent event). The predecessor accountant also would dual-date the report if the prior-period financial statements are adjusted for the correction of an error or other prior period adjustments. In those circumstances, the

adjustment to the financial statements would be discussed in a note to the financial statements, and the predecessor accountant's report would be dual-dated with respect to the note.

AU-C 560.A16 permits one exception to this dual-dating rule. If the financial statements are changed because of the occurrence of a subsequent event that requires disclosure only, the event may be disclosed in a separate note to the financial statements captioned "Event (Unaudited) Subsequent to the Date of the Accountant's Report". In the case of a reissued report, such an event would be either (a) a "recognized" subsequent event that occurs between the original issuance and the reissuance of the financial statements and, therefore, is only disclosed as explained above or (b) a "non-recognized" subsequent event. However, the authors believe that this approach is appropriate only if financial statements and an accountant's report are reissued separately (that is, not as part of comparative financial statements). If reissuance occurs as part of comparative financial statements, the event is covered in the current period financial statements, and a subsequent event caption seems inappropriate. Under either approach, the predecessor accountant's report would be dated the same as the original report.

Client-prepared Financial Statements

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, the authors believe 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 report on compiled or reviewed financial statements, in reality, the accountant 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. When the accountant becomes aware that such a "new document" will be created by the client, the authors believe 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 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, or review the client-prepared statement.

Comparative Financial Statements–Prior Year Has Not Been Audited, Reviewed, or Compiled. If a client asks an accountant to compile the current year financial statements and present the prior year financial statements in a comparative format when the prior year financial statements have not been audited, reviewed, or compiled, the authors believe the accountant should not present the prior year financial statements unless they have been engaged to compile them. Even if the prior year financial statements had been prepared by the accountant, the

accountant would need to be engaged to compile them. The engagement letter would include the compilation on both the current and prior year financial statements.

The Client's Disclaimer. As previously noted, if a client-prepared document mentions the accountant's name in any manner, the authors believe any client-prepared financial statements in such document need to (a) be presented on a page separate from compiled or reviewed 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, the accountant may add the following disclaimer to his or her report before it is delivered to the client (as illustrated earlier in this lesson for client-prepared supplementary information).

> 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 Independence Impairment When the Independence is Impaired in Only One Period

According to Q&A 9150.30, in the accountant's compilation report on comparative financial statements when the accountant *was not* independent for the earlier period, but *is* independent for the subsequent period, the accountant may indicate the independence impairment for the earlier period by including language such as the following as the final paragraph of the accountant's compilation report—

> As of and for the year ended December 31, 20X1, I was not independent with respect to ABC Company.

The accountant is not precluded from disclosing a description about the reason(s) that the accountant's independence was impaired. If the accountant discloses a description about the reason(s) independence is impaired, the accountant should ensure that all the reasons for not being independent are included in the description [AR-C 80.23 (AR-C 80A.23)].

In addition, the accountant is not required to make, but is not precluded from making, a disclosure that his or her independence was subsequently cured. Such a disclosure might read as follows—

> As of and for the year ended December 31, 20X1, I was not independent with respect to ABC Company. I am currently independent with respect to ABC Company.

As discussed above, the accountant is not precluded from disclosing a description about the reason(s) that the accountant's independence was impaired.

REPORTING WHEN ACCOUNTING CHANGES HAVE OCCURRED

FASB ASC 250-10-20 defines an accounting change as one of the following:

- Change in accounting estimate.
- Change in reporting entity.
- Change in accounting principle.

The correction of an error in previously issued financial statements, which is discussed later in this lesson, is not deemed to be an accounting change under FASB ASC 250-10.

Change in Accounting Estimate

A change in accounting estimate results from additional information or new developments and does not require prior period adjustment. Examples of accounting estimates that periodically change are allowances for bad debts, useful lives of depreciable assets, and estimated annual tax rates. The effect of changes in estimates should be reported in the period of the change and subsequent periods (FASB ASC 250-10-45-17). Restatement of prior periods is not appropriate. Disclosure of a change in an accounting estimate is necessary if the change affects several future periods, such as a change in the useful lives of depreciable assets, or if the effect of the change is material.

FASB ASC 250-10-45-18 through 45-20 requires a change in the method of depreciation, amortization, or depletion for long-lived nonfinancial assets to be accounted for as a change in accounting estimate effected by a change in accounting principle. Those changes are considered changes in estimates.

If the disclosure described above is not included in the financial statements, accountants are required to modify their compilation or review reports for a change in accounting estimate. Otherwise, modification of the report is unnecessary.

Change in Reporting Entity

A change in reporting entity refers to a change that results in financial statements that are, in effect, the statements of a different reporting entity. Typically, such changes are limited to changes in the companies or subsidiaries that are included in combined or consolidated financial statements. A change in the legal form of business, e.g., sole proprietorship to corporation, is not a change in reporting entity. When an accounting change results in financial statements that are effectively the statements of a different reporting entity, the change should be retrospectively applied to the financial statements of all prior periods presented (FASB ASC 250-45-21). The financial statements of the period of change shall describe the nature of the change and the reason for it. In addition, disclosure of the effect of the change on income before extraordinary items, net income, and other comprehensive income for all periods presented is required.

A change in reporting entity would not cause accountants to modify their compilation or review reports, unless the necessary disclosures described in the preceding paragraph are not included in the financial statements.

Change in Accounting Principle

A change in accounting principle is generally defined as a change from one acceptable accounting principle to another or a change in the method of applying an acceptable accounting principle. An example of changes in accounting principle would be a change in the method of pricing inventories (e.g., FIFO to LIFO). A change from an unacceptable method to an acceptable method is a correction of an error and not a change in accounting principle.

Accounting for a Change in Accounting Principle. FASB ASC 250-10 establishes standards for accounting for and reporting of a change in accounting principle. It applies to all voluntary changes in accounting principle as well as to changes required by an accounting pronouncement when that pronouncement does not include explicit transition provisions. If a pronouncement includes explicit transition provisions, those provisions should be applied.

According to FASB ASC 250-10-45-5 to 45-8, a change in accounting principle should be reported by retrospective application of the new principle to the financial statements of all prior periods, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. *Retrospective application* is the application of a different accounting principle to previous accounting periods as if it had always been used. The following steps are required to retrospectively apply a new accounting principle:

a. Determine the cumulative effect of the change to the new accounting principle on periods before the periods presented. Apply the cumulative effect of the change to the carrying amounts of assets and liabilities as of the beginning of the first period presented.

b. If necessary, record an offsetting adjustment to the opening retained earnings balance for that period.

c. Adjust the financial statements for each individual prior period presented to reflect the period-specific effects of applying the new accounting principle.

If the cumulative effect of applying the change to all prior periods can be determined, but it is impracticable to determine the period-specific effects of the change on all prior periods presented, the cumulative effect of the change should be applied to the balances of assets and liabilities as of the beginning of the earliest period to which the new principle can be applied. In those situations, an offsetting adjustment to the opening retained earnings balance for that period may be necessary. If it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, the new principle should be applied as if it were adopted prospectively from the earliest date practicable.

When applying a new accounting principle retrospectively, an entity should include only the direct effects of the change and the related income tax effects, if any. The retrospective application should not include any indirect effects that would have been recognized if the new principle had been used in previous periods. Indirect effects of the change that are actually incurred and recognized should be reported in the period the change is made. An example of an indirect effect is a change in a nondiscretionary profit-sharing contribution that is based on net income.

Accounting Change Prescribed by New Pronouncements. Almost all recent FASB pronouncements require or permit retrospective application when new accounting principles prescribed by them are adopted.

Justification for a Change in Accounting Principle. A company should not change an accounting principle unless the proposed principle also is in conformity with generally accepted accounting principles, and management believes that the new principle is preferable in the circumstances (FASB ASC 250-45-2). FASB ASC 250-10-50-1 requires that the nature of a change in accounting principle, management's justification for the change, and the effect of the change in accounting principle be disclosed in the financial statements of the period in which the change is made. Illustrations of note disclosures of accounting changes are found in *PPC's Guide to Compilation and Review Engagements* and in the *Trends* volume of *PPC's Guide to Preparing Financial Statements*. [To order, call (800) 431-9025 or visit **tax.thomsonreuters.com**.]

Reporting on a Change in Accounting Principle. Accountants are not required to modify their compilation and review reports provided the change is properly accounted for and adequately disclosed in the financial statements. (That differs from the guidance for auditors discussed in AU-C 708. That guidance requires auditors to add a paragraph to their report when accounting principles have not been consistently applied from one period to the next. Thus, auditors are required to add an explanatory paragraph to their report to highlight a change in accounting principle.)

Although not required by AR-C 80 (AR-C 80A) or AR-C 90 (AR-C 90A), accountants may add an emphasis-of-matter paragraph to their report if they wish. Pre-SSARS No. 25 (AR-C 90A.53a) requires the emphasis-of-matter paragraph to be placed immediately after the conclusion paragraph in review reports. SSARS No. 25 (AR-C 90.89) does not prescribe a placement for the emphasis-of-matter paragraph in review reports. No placement is prescribed before or after implementing SSARS No. 25 in compilation reports. 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 method of pricing inventories from the first-in, first-out method to the last-in, first-out method.

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 GAAP departure.

REPORTING WHEN A CLIENT IS A NONPROFIT ORGANIZATION

There may be instances where the accountant is engaged to perform services relating to a nonprofit organization's financial statements that are less in scope than an audit. For example, the governing body or a grantor agency may want a level of comfort regarding the organization's financial statements that can be accomplished through a review of the financial statements rather than an audit.

In addition, because the independence rules of *Government Auditing Standards* (the Yellow Book) may restrict the services a firm can perform for a nonprofit client, organizations that require a Yellow Book audit and also need a lot of bookkeeping assistance may need assistance from a firm other than their auditor. In general, a firm that performs a Yellow Book audit is prohibited from performing "nonaudit services" for its audit client. Paragraph 3.70 of the 2018 Yellow Book explains that activities such as preparing financial statements and converting cash basis financial statements to accrual basis statements are nonaudit services. And, if in addition to the bookkeeping services the client wishes the firm to assist with the presentation of the financial statements and to report on them, the firm would be required to at a minimum compile the statements. If no report is required, the firm could instead be engaged to prepare the financial statements under an engagement subject to AR-C 70 (AR-C 70A). Those financial statements could then be audited by the audit firm.

An accountant employs the same procedures in the compilation or review of a nonprofit organization's financial statements as those used in other compilation or review engagements, except the specialized accounting standards for nonprofit organizations are required to be taken into consideration when obtaining an understanding of the organization's financial reporting framework, the significant accounting policies to be used in the preparation of the financial statements, and in reading the financial statements to determine whether they are appropriate in form and free from obvious material misstatements. And in a review, these unique standards would also be taken into consideration when making inquiries and performing analytics [AR-C 90 (AR-C 90A)]. More specifically, the accountant needs to be familiar with the accounting and financial reporting requirements in GAAP (or other applicable financial reporting framework) that apply specifically to nonprofit organizations. For example—

- The industry-specific accounting standards established by FASB ASC 958 and other relevant nonauthoritative guidance such as that provided in the AICPA's *Audit and Accounting Guide—Not-for-Profit Entities*.
- The accounting for donated property, promises to give, donated services, or collections.
- The functional classification of expenses, including fund-raising expenses, and other functional expense information.
- The classification and presentation of net assets without donor restrictions and net assets with donor restrictions.
- Transactions that represent agency transactions.
- Transactions that give rise to significant payables or accruals, such as promises to give contributions or liabilities to beneficiaries under split-interest agreements.
- The legal status, tax status, and type of organization (such as voluntary health and welfare, arts organization, religious entity, or private school).
- The accounting for investments, including the classification of gains and losses on investments of donor-restricted endowments.
- Transactions giving rise to taxes on unrelated business income.

Obtaining a representation letter is also a required procedure in a review engagement. The general content of the representation letter is discussed in Lesson 1. However, the accountant may need to consider whether it is appropriate to add representations tailored for a nonprofit engagement, such as the following—

- The Organization is an exempt organization under Section 501(c)(3) (or applicable section) of the Internal Revenue Code.
- There are no designations of net assets that were not properly authorized and approved or reclassifications of net assets that have not been properly reflected in the financial statements.
- We have complied with all restrictions on resources (including donor restrictions) and all aspects of contractual and grant agreements that would have a material effect on the financial statements in the event of noncompliance. This includes complying with donor requirements to maintain a specific asset composition necessary to satisfy their restrictions.

As with any compilation or review, there is no complete list of items that the accountant needs to consider in evaluating whether the form of the financial statements appears to be appropriate and whether the statements are free from material misstatements. The accountant applies professional judgment in the context of the specific characteristics of the engagement in order to satisfy the standards established by AR-C 80 (AR-C 80A) or AR-C 90 (AR-C 90A).

For more information on nonprofit engagements, see *PPC's Guide to Audits of Nonprofit Organizations* and *PPC's Guide to Preparing Nonprofit Financial Statements*.

Once the accountant has completed the appropriate compilation or review procedures and successfully implemented the requirements established by AR-C 80 (AR-C 80A) or AR-C 90 (AR-C 90A), respectively, a compilation or review report on the nonprofit organization's financial statements would be issued.

REPORTING WHEN THE CLIENT IS A GOVERNMENTAL ENTITY

As with nonprofits, instances may exist where the accountant is engaged to perform services relating to a governmental entity's financial statements that are less in scope than an audit. For example, some states have requirements for financial reports in addition to the audited financial statements. Certain of these states require school districts to file an annual report in a prescribed format that includes financial and statistical data. This annual report is used for allocating state aid and similar functions and is due shortly after year end, but well before the audit can be completed. Thus, the financial statements included in this form are normally compiled.

Although the compilation or review of financial statements of a governmental entity is similar to other compilation or review engagements, because of the nature of governments in general the accountant needs to consider the accounting standards unique to governmental entities when obtaining an understanding of the entity and its industry and in reading the financial statements to determine whether they are appropriate in form and free from obvious material errors. These unique standards need to be taken into consideration when making inquiries and performing analytics [AR-C 90 (AR-C 90A)]. More specifically, the accountant considers—

- The accounting standards established by the Governmental Accounting Standards Board (GASB)
- The financial reporting entity.
- Transactions that give rise to the governmental entity's major sources of revenue, grants, and other support.
- Transactions that represent significant program-services.
- Transactions related to investment strategies of the governmental entity.
- How the governmental entity identifies activities to be reported as proprietary activities.

In a review engagement, AR-C 90 (AR-C 90A) requires that the accountant obtain a representation letter. The general content of the representation letter is discussed in Lesson 1. However, the accountant may consider adding the following additional representation for a governmental entity—

> We are responsible for compliance with the laws, regulations, and provisions of contracts and grant agreements applicable to us, including tax or debt limits and debt contracts; and we have identified and disclosed to you all laws, regulations, and provisions of contracts and grant agreements that we believe have a direct and material effect on the determination of financial statement amounts, including legal and contractual provisions for reporting specific activities in separate funds.

As with any compilation or review, there is no complete list of items that the accountant needs to consider in evaluating whether the financial statement form appears to be appropriate and free from obvious material errors. The accountant applies professional judgment in the context of the specific characteristics of the compilation or review engagement in order to satisfy the standards established by AR-C 80 (AR-C 80A) or AR-C 90 (AR-C 90A), respectively.

For more information on governmental entity engagements, see *PPC's Guide to Preparing Governmental Financial Statements* and *PPC's Guide to Audits of Local Governments*.

At the conclusion of the compilation or review engagement, the accountant issues an appropriate compilation or review report on the governmental entity based on the findings of the engagement.

SELF-STUDY QUIZ

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

13. Which of the following statements best describes drafting a compilation or review report on comparative financial statements?

    a. The focus of the report will be the current period and the accountant will typically not refer to the other periods in the report.

    b. If there is a change in level of service between the financial statement periods being compared, the report should not include a title so as not to be misleading.

    c. The report is usually simple to draft unless certain changes occur, such as different levels of service or new financial reporting standards.

    d. In essence, the accountant is writing a new report on both the current set of financial statements and the prior set that is being compared.

14. What is the most cost-effective method for a successor accountant to address a change in accountants in a compilation or review report on comparative financial statements?

    a. Contact the predecessor accountant and requesting that he or she reissue the report on the prior period financial statements.

    b. Refer to the predecessor's report in an other-matter paragraph in the report on the current period financial statements.

    c. Perform compilation or review procedures on the prior period financial statements and issue a new report on them.

    d. Include a note that the predecessor has ceased operations and present their findings on the prior period financial statements as is.

15. Owl Inc. paid Lee to review its financial statements. Later, Lee finds out that Owl Inc. is including his report and mentioning him by name in a new document with client-prepared financial statements. The client-prepared information is included on a separate page from the financial statements that Lee reviewed and his review report. How should Lee proceed?

    a. Lee should request that Owl Inc. add a disclaimer indicating he assumes no responsibility for the new statements.

    b. Lee should inform Owl Inc. that he will need to also review the client-prepared statement if his name is to be included in the document.

    c. Lee should request that Owl Inc. remove all mentions of his name and his firm from the entire document.

    d. Lee does not need to take action because his work is presented separately from the information prepared by Owl Inc.

16. What is an example of a *change in accounting principle*?

    a. Changing from FIFO to LIFO.

    b. Changing the allowance for bad debts.

    c. Including a new subsidiary in combined financial statements.

    d. Updating estimated annual tax rates.

17. Which of the following statements best describes how compilation and review engagements relate to nonprofit organizations?

    a. Accountants are prohibited from providing services to nonprofit organizations that are lower in scope than an audit.

    b. Compilations or reviews of a nonprofit organization's financial statements are the same as those of other entities.

    c. The accountant will need familiarity with GAAP requirements that apply specifically to nonprofit organizations.

    d. Obtaining a representation letter will be necessary in both a compilation and a review of a nonprofit organization's 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 in this lesson. **(References are in parentheses.)**

13. Which of the following statements best describes drafting a compilation or review report on comparative financial statements? **(Page 217)**

    a. The focus of the report will be the current period and the accountant will typically not refer to the other periods in the report. [This answer is incorrect. When financial statements of two or more periods are presented in columnar form, the accountant reports on each period presented, not just the current period. At a minimum, the report would need certain small changes, such as making certain terms plural.]

    b. If there is a change in level of service between the financial statement periods being compared, the report should not include a title so as not to be misleading. [This answer is incorrect. AR-C 80 (AR-C 80A) does not include a requirement that the accountant's compilation report include a title. However, AR-C 90 (AR-C 90A) *does* include a requirement that the accountant's review report include a title with the word *Independent*, such as "Independent Accountant's Review Report." If there is a change in the level of service, this course recommends using a generic title such as "Independent Accountant's Report," so the reader will not be confused about the level of service provided on each set of statements.]

    c. **The report is usually simple to draft unless certain changes occur, such as different levels of service or new financial reporting standards. [This answer is correct. The accountant's report on comparative financial statements is relatively simple to draft if certain changes have not occurred. However, situations do change, e.g., clients change accountants, clients request different levels of service, clients change their status as an issuer or a nonpublic entity, additional information regarding previously issued financial statements becomes available, and new financial reporting standards evolve. Each of these changes can complicate the accountant's report on comparative financial statements.]**

    d. In essence, the accountant is writing a new report on both the current set of financial statements and the prior set that is being compared. [This answer is incorrect. The accountant is, as of the date of the current report, *updating* his or her report on the financial statements of the prior period, not reporting on the prior period anew.]

14. What is the most cost-effective method for a successor accountant to address a change in accountants in a compilation or review report on comparative financial statements? **(Page 223)**

    a. Contact the predecessor accountant and requesting that he or she reissue the report on the prior period financial statements. [This answer is incorrect. This is one of the options available when this type of situation arises; however, it is not the most cost efficient for the client. The predecessor will need to be paid for that work, and it raises the question about who the predecessor bills—the successor accountant or the client who may have fired the predecessor.]

    b. **Refer to the predecessor's report in an other-matter paragraph in the report on the current period financial statements. [This answer is correct. If the current accountant chooses to refer in his or her report on comparative financial statements to the report of the predecessor accountant, the accountant would do so by adding one or more other-matter paragraphs to his or her report on the current period financial statements. Of the options available in this situation, making reference to the predecessor accountant's report in this way is generally the simplest and least costly approach for the client.]**

    c. Perform compilation or review procedures on the prior period financial statements and issue a new report on them. [This answer is incorrect. This method requires more work on the part of the successor accountant, which the client will have to pay for, so it is not the most cost-effective option.]

d. Include a note that the predecessor has ceased operations and present their findings on the prior period financial statements as is. [This answer is incorrect. The question does not specify that the predecessor accountant has ceased operations; therefore, there is a better answer to this question. However, even if that were the case, the successor accountant would need to make several determinations before deciding how to address the issue in the current period financial statements. Simply making note that the predecessor is unavailable might not be enough in all instances, particularly if the prior period statements have been restated.]

15. Owl Inc. paid Lee to review its financial statements. Later, Lee finds out that Owl Inc. is including his report and mentioning him by name in a new document with client-prepared financial statements. The client-prepared information is included on a separate page from the financial statements that Lee reviewed and his review report. How should Lee proceed? **(Page 227)**

    a. **Lee should request that Owl Inc. add a disclaimer indicating he assumes no responsibility for the new statements. [This answer is correct. If the accountant's name is mentioned in the new client-prepared document, like Lee's is in this scenario, a distinction is made based on how the information is formatted. If the client-prepared information is presented on a separate page, all Lee needs to do is request that Owl Inc. add a disclaimer. The disclaimer should be a clear indication from the client that the accountant has not audited, reviewed, or compiled those financial statements and that the accountant assumes no responsibility for them.]**

    b. Lee should inform Owl Inc. that he will need to also review the client-prepared statement if his name is to be included in the document. [This answer is incorrect. If Owl Inc. had presented the client-prepared information alongside the financial statements that were compiled/reviewed by Lee (i.e., *not* on a separate page), Lee should advise Owl Inc. about their options, one of which would be to have him also prepare, compile, or review the client-prepared information. However, this level of work would not be necessary based on the formatting described above, so there is a more appropriate answer choice.]

    c. Lee should request that Owl Inc. remove all mentions of his name and his firm from the entire document. [This answer is incorrect. If Owl Inc. had presented the client-prepared information alongside the financial statements that Lee reviewed, one of Lee's options would be to advise Owl Inc. to remove all mention of his name from the document. However, because Owl Inc. did not format the new document that way, a different action would be a better choice for Lee in this situation.]

    d. Lee does not need to take action because his work is presented separately from the information prepared by Owl Inc. [This answer is incorrect. If Lee's name were in no way mentioned in the new client-prepared document, he would have no other responsibility. However, since Lee's information has been included, he will need to address the situation further.]

16. What is an example of a change in *accounting principle*? **(Page 229)**

    a. **Changing from FIFO to LIFO. [This answer is correct. A change in accounting principle is generally defined as a change from one acceptable accounting principle to another or a change in the method of applying an acceptable accounting principle. An example of changes in accounting principle would be a change in the method of pricing inventories (e.g., FIFO to LIFO).]**

    b. Changing the allowance for bad debts. [This answer is incorrect. This is an example of a change in accounting estimate, not in accounting principle. Changes in accounting estimates result from additional information or new developments and do not require a prior period adjustment.]

    c. Including a new subsidiary in combined financial statements. [This answer is incorrect. A change in reporting entity (not accounting principle) refers to a change that results in financial statements that are, in effect, the statements of a different reporting entity. Typically, such changes are limited to changes in the companies or subsidiaries that are included in combined or consolidated financial statements.]

d. Updating estimated annual tax rates. [This answer is incorrect. This would be considered a change in accounting estimate, not a change in accounting principle, because it is based on new information.]

17. Which of the following statements best describes how compilation and review engagements relate to nonprofit organizations? **(Page 231)**

a. Accountants are prohibited from providing services to nonprofit organizations that are lower in scope than an audit. [This answer is incorrect. There may be instances where the accountant is engaged to perform services relating to a nonprofit organization's financial statements that are less in scope than an audit. For example, the governing body or a grantor agency may want a level of comfort regarding the organization's financial statements that can be accomplished through a review of the financial statements rather than an audit.]

b. Compilations or reviews of a nonprofit organization's financial statements are the same as those of other entities. [This answer is incorrect. An accountant does employ most of the same procedures in the compilation or review of a nonprofit organization's financial statements as those used in other compilation or review engagements. However, there are differences that should be taken into account.]

c. **The accountant will need familiarity with GAAP requirements that apply specifically to nonprofit organizations. [This answer is correct. Accountants must take into consideration the specialized accounting standards for nonprofit organizations when obtaining an understanding of the organization's financial reporting framework, the significant accounting policies to be used in the preparation of the financial statements, and in reading the financial statements to determine whether they are appropriate in form and free from obvious material misstatements. And in a review, these unique standards would also be taken into consideration when making inquiries and performing analytics. Therefore, the accountant needs to be familiar with the accounting and financial reporting requirements in GAAP that apply specifically to nonprofit organizations, even when performing a compilation or a review instead of an audit.]**

d. Obtaining a representation letter will be necessary in both a compilation and a review of a nonprofit organization's financial statements. [This answer is incorrect. Obtaining a representation letter is a required procedure for a review engagement with a nonprofit organization, but not for a compilation.]

OTHER REPORTING SITUATIONS THAT MAY BE ENCOUNTERED

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 Statements and Specific Elements, Accounts, or Items of a Financial Statement*, and discussed in *PPC's Guide to Nontraditional Engagements*. According to AU-C 805 (AU-C 805B), 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 AT-C 215, *Agreed-Upon Procedures Engagements*, may also be applied.

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 (AR-C 80A) and AR-C 90 (AR-C 90A), respectively. AR-C 80.01 (AR-C 80A.01) and AR-C 90.01 (AR-C 90A.01) indicate that AR-C 80 (AR-C 80A) and AR-C 90 (AR-C 90A) apply to engagements to compile and review historical information other than financial statements. In addition, AR-C 80.A3 (AR-C 80A.A3) and AR-C 90.A2 (AR-C 90A.A2) list specified elements as types of historical financial information to which the guidance in AR-C 80 (AR-C 80A) and AR-C 90 (AR-C 90A) applies. When the accountant is engaged to compile one or more specified elements, accounts, or items of a financial statement, compilation procedures would be modified as appropriate for such an engagement. When the accountant is engaged to review one or more specified elements, accounts, or items of a financial statements, review procedures would be modified as appropriate for such an engagement. The reporting guidance discussed throughout this lesson would be modified as appropriate as well.

However, 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.

Compliance with Aspects of Contractual Agreements or Regulatory Requirements

AU-C 806 discusses situations in which entities may be required by contractual agreements, such as bond indentures and certain types of loan agreements, to furnish *compliance reports* (not to be confused with compilation reports defined in AR-C 80 (AR-C 80A) or with financial statements prepared in accordance with a contractual agreement, as discussed in AR-C 80.19 (AR-C 80A.19)) by independent auditors. In a compliance report, auditors generally express negative assurance (that is, "nothing came to our attention") about the entity's compliance with certain covenants of a bond indenture or loan agreement. AU-C 806 indicates that such assurances in *compliance reports* should not be given unless the auditor has audited the financial statements to which the contractual agreement or regulatory requirements relate. The authors believe that a compilation or review service is not an adequate basis upon which to furnish a *compliance report*.

Accountants providing compilation or review services can, however, report on compliance through a separate engagement. Such engagements may vary from an examination of management's compliance to an agreed-upon procedures engagement that provides information about the entity's compliance. *PPC's Guide to Nontraditional Engagements* discusses compliance engagements in detail.

Split-level Reporting

Split-level reporting involves providing different levels of assurance on a single set of financial statements (for example, auditing the balance sheet and reviewing the income statement). Authoritative literature does not address whether an accountant can audit a balance sheet and review an income statement for the same set of financial statements. The authors believe that an engagement involving an audit of one statement and a review of another statement, e.g., 20X1 balance sheet audited/20X1 income statement reviewed, should be avoided.

In a first year audit, when the beginning inventory has not been observed but no other scope limitations are encountered, the accountant sometimes finds that he or she cannot express an opinion on the statements of income, retained earnings, and cash flows. The accountant may, however, be able to express an unmodified opinion on the

balance sheet. In such a situation, is it permissible to audit the balance sheet and compile or review the statements of income, retained earnings, or cash flows? In the authors' opinion, the answer is no for this situation.

The accountant should follow auditing literature AU-C 705 (AU-C 705B) and indicate that he or she does not express an opinion on the statements of income, retained earnings, and cash flows. The rationale for this is that the audit disclaimer is more appropriate since it carries more assurance than a compiled or reviewed report. Since the accountant has applied audit procedures to the results of operations and the statement of cash flows, except for beginning inventory, it is not appropriate to issue a compilation or review report. See Q&A 9080.04 for additional guidance.

Another frequently encountered practice problem is a limited reporting engagement involving an *audited* balance sheet of a nonpublic entity that is presented with *unaudited* statements of income, retained earnings, and cash flows. In this situation, the authors believe that the accountant's report would not state that he or she has compiled or reviewed the unaudited statements. Instead, the accountant's report would simply indicate that the statements of income, retained earnings, and cash flows were not audited and no opinion is expressed on them.

The previous discussion addresses situations when it might seem appropriate to apply auditing standards and SSARS to the same set of financial statements. However, as indicated, the authors believe that auditing literature should be followed, not SSARS.

What about an engagement involving a reviewed balance sheet and a compiled statement of income? Is this appropriate? Again, this is not addressed in authoritative literature, so it is not prohibited. However, the authors believe that it is not generally appropriate to provide this kind of service. Usually when one statement has been reviewed, the additional work necessary to review the other statements is minimal.

Use of Additional, 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 pertaining to the financial statements. Additional, emphasis-of-matter, or other-matter paragraphs may be included in the accountant's compilation or review report as a requirement of the SSARS or at the accountant's discretion.

An emphasis-of-matter paragraph generally calls attention to a matter presented or disclosed in the financial statements that, in the accountant's professional judgment, is important to the users' understanding of the financial statements or is required to be included by the SSARS. Examples include paragraphs addressing going-concern problems, litigation matters, or related-party transactions. Emphasis-of-matter paragraphs are addressed in AR-C 90 (AR-C 90A) as they relate to review reports, but are not discussed in AR-C 80 (AR-C 80A). Paragraph 2.81 of the AICPA Guide indicates there is no prohibition to the inclusion of emphasis-of-matter or other-matter paragraphs in compilation reports and, indeed, AR-C 80 (AR-C 80A) does require an *additional* paragraph in certain instances. Prior to implementing SSARS No. 25, AR-C 90A.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.

After implementing SSARS No. 25, AR-C 90.89 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 has obtained sufficient appropriate review evidence to conclude that the accountant is not aware of any material modifications that should be made to the financial statements with respect to such matter.

An other-matter paragraph refers to a matter other than those presented or disclosed in the financial statements that is required by the SSARS or, in the accountant's professional judgment, is 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. As noted above concerning emphasis-of-matter paragraphs, AR-C 80 (AR-C 80A) does not discuss the use of other-matter paragraphs in compilation reports, and Paragraph 2.81 of the AICPA Guide indicates their use is not prohibited.

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 [AR-C 90.93 (AR-C 90A.55)].

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 (AR-C 80A.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 (AR-C 80A.22)].

c. When substantially all disclosures are omitted, the compilation report should disclose the omission [AR-C 80.27 (AR-C 80A.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.

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 (AR-C 80A.34–.36)].

f. When required supplementary information is included with the financial statements and the accountant's compilation report, the report should include an other-matter paragraph [AR-C 80.37–.39 (AR-C 80A.37–.39)].

The accountant is required to include an emphasis-of-matter or other-matter paragraph in the accountant's review report 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 90.80 (AR-C 90A.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 90.55 (AR-C 90A.76c)].

c. The accountant's review report when the financial statements are prepared in accordance with a special purpose framework 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) an other basis of accounting (AR-C 90A.44). After implementing SSARS No. 25, a paragraph that restricts the use of the accountant's review report is only required when the financial statements are prepared in accordance with the contractual basis of accounting (AR-C 90.81).

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 90.86 (AR-C 90A.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 90.87 (AR-C 90A.50)].

f. Before implementing SSARS No. 25, 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 90A.56–.60). After implementing SSARS No. 25, departures from the applicable financial reporting framework result in a modified conclusion.

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 90.126–.128 (AR-C 90A.83–.85)].

h. When required supplementary information is included with the financial statements and the accountant's review report, the report should include an other-matter paragraph [AR-C 90.129–.131 (AR-C 90A.86–.88)]. A separate report may be issued on the supplementary information instead.

i. Prior to implementing SSARS No. 25, AR-C 90A.67 requires an emphasis-of-matter paragraph in the accountant's review report when, after considering conditions or events and management's plans, the accountant concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains. After implementing SSARS No. 25, AR-C 90.109 requires a separate section in the accountant's review report with the heading "Substantial Doubt About the Entity's Ability to Continue as a Going Concern," when after considering conditions or events and management's plants, the accountant concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains.

j. After implementing SSARS No. 25, AR-C 90.94 requires the accountant to include an emphasis-of-matter paragraph in the accountant's review report when there are adjustments to correct a material misstatement in previously issued financial statements.

Some practitioners include an other-matter paragraph in their compilation report on financial statements that omit substantially all disclosures to explain why there is no tax provision in the financial statements for a partnership or S corporation. The authors believe that in a non-disclosure compilation report this other-matter paragraph is not needed and, in fact, should not be included.

While accountants can make whatever disclosures they deem appropriate in their compilation or review report, the authors nevertheless recommend that accountants avoid using additional, emphasis-of-matter, or other-matter paragraphs when not required. Such paragraphs require the accountants to choose the information pertaining to 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 by GAAP 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 required additional, emphasis-of-matter, and other-matter paragraphs listed above, the following are examples of circumstances when the accountant may consider it necessary to include such a paragraph:

a. An uncertainty of an entity's ability to continue as a going concern for a reasonable period of time in a compilation.

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.

When the accountant includes an additional, emphasis-of-matter, or other-matter paragraph it should [AR-C 90.90–.92 (AR-C 90A.53–.54)]:

a. Be immediately after the accountant's conclusion paragraph in the accountant's review report prior to implementing SSARS No. 25 (AR-C 90A.53a). SSARS No. 25 (AR-C 90.89) does not prescribe a placement for the emphasis-of-matter paragraph or other matter paragraph in review reports. No placement is prescribed before or after implementing SSARS No. 25 in compilation reports.

b. In a review report, have a heading titled "Emphasis of a Matter," "Other 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.

Reporting on Uncertainties

Uncertainties include, but are not limited to, contingencies covered by FASB ASC 450, *Contingencies*, and matters related to estimates covered by FASB ASC 275-10, *Risks and Uncertainties*. Examples include—

a. Lawsuits when the outcome cannot be determined.

b. Tax claims asserted by tax authorities when precedents are not clear and potential liability cannot be determined. (This should not be confused with the normal uncertainty surrounding the calculation of the current year tax provision or liability.)

c. Actions by governmental regulatory agencies.

d. Recoverability of certain assets when the outcome depends on future operations or market conditions that cannot be evaluated with any degree of reliability.

e. Contracts in renegotiation or dispute.

Uncertainties should not be confused with the dollar amount of estimates or accruals to which the accountant takes exception. Differences between the client's recorded estimate and the accountant's best estimate should not be considered uncertainties. Such differences, if material and not adjusted, are departures from GAAP that should be reported on in accordance with the guidance provided earlier in this lesson.

With the exception of going concern uncertainties that exist in a review engagement, the accountant may include, but is not required to include, an emphasis-of-matter paragraph in the accountant's compilation report or review report, as applicable, if an uncertainty exists. The authors believe, however, that in some situations, the significance of an uncertainty may warrant such emphasis-of-matter paragraph in the accountant's compilation or review report. Two of the most difficult uncertainties to evaluate are (a) a going concern problem and (b) a lawsuit. Those subjects are discussed in the following paragraphs.

Going-concern Uncertainties

Ordinarily, financial statements are prepared based on the presumption that the entity to which they relate will continue as a going concern. However, situations may arise when the entity is no longer able to meet its obligations as they come due without substantial disposal of assets, restructuring its debt, externally forced revisions of its operations, or similar actions. Such situations also may stem from other factors such as loss of key personnel, principal customers, sources of supply, or primary revenue-producing assets.

Prior to implementing SSARS No. 25, AR-C 90A.67 requires the accountant to include an emphasis-of-matter paragraph in the accountant's review report if, after considering conditions or events and management's plans, the

accountant concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains.

After implementing SSARS No. 25, if after considering conditions or events and management's plans, the accountant concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, AR-C 90.109 requires a separate section in the accountant's review report with the heading "Substantial Doubt About the Entity's Ability to Continue as a Going Concern" that does the following:

- Draws attention to the note in the financial statements that discloses:
  - the conditions or events identified and management's plans to deal with those conditions or events, and
  - that those conditions or events indicate that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time.
- States that the accountant's conclusion is not modified with respect to the matter.

After implementing SSARS No. 25, if adequate disclosure about the entity's ability to continue as a going concern for a reasonable period of time is not made in the financial statements, the accountant should—(AR-C 90.111)

a. Express a modified conclusion.

b. In the "Basis for Qualified Conclusion" section or "Basis for Adverse Conclusion" section, as appropriate, state—

   (1) substantial doubt exists about the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter or

   (2) substantial doubt about the entity's ability to continue as a going concern has been alleviated by management's plans, but the financial statements do not adequately disclose this matter.

AR-C 90.A179 (AR-C 90A.A125) states that if conditions or events have been identified that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, but based on evidence obtained during the review, the accountant concludes that substantial doubt has been alleviated by management's plans and adequate disclosure has been made in the financial statements, the accountant may include an emphasis-of-matter paragraph which references management's disclosures related to the conditions or events and management's plans for those conditions or events. SSARS No. 25, states that in this circumstance, the use of an emphasis-of-matter paragraph is to draw users' attention to the disclosures of the conditions and events and management's plans. It is distinguished from the situation in which the accountant concludes, after considering the identified conditions or events and management's plans, that substantial doubt about the entity's ability to continue as a going concern remains, in which case the accountant is required to include a separate going concern section in the accountant's review report.

The accountant should not use conditional language in the emphasis-of-matter paragraph concerning the existence of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The accountant should, instead, use language consistent with the language used in the applicable financial reporting framework. AR-C 90.A181 (AR-C 90A.A126) provides the following examples of inappropriate use of conditional language in an emphasis-of-matter paragraph in the accountant's review report when the accountant concludes that management has adequately disclosed that conditions or events have been identified and substantial doubt about the entity's ability to continue as a going concern exist:

- If the Company continues to experience recurring losses from operations and continues to have a net capital deficiency, there may be substantial doubt about its ability to continue as a going concern.
- The Company has been unable to renegotiate its expiring credit agreements. Unless the Company is able to obtain financial support, there is substantial doubt about its ability to continue as a going concern.

An inadequate disclosure about an entity's ability to continue as a going concern for a reasonable period of time would be considered a departure from the applicable financial reporting framework. In these instances the reporting guidance for financial statements that have departures from GAAP discussed earlier in this lesson should be followed.

COVID-19 Implications on Going Concern. The topic of going concern is especially relevant right now, given the many uncertainties from the current health and economic crises. Companies of all sizes in all industries have been faced with closures of specific locations or complete shutdowns, employee layoffs and restrictions on work, liquidity issues, and disruptions to their supply chains and customers. Revenues have been negatively impacted as a result. While some entities may not be negatively impacted by the COVID-19 global pandemic, entities in many different industries and locations will experience negative impacts that need to be evaluated. Few businesses will escape the repercussions of the pandemic. As a result, most entities will have some amount of doubt about events and conditions that could indicate a going concern problem. For review engagements, the impact on the report needs to be considered as well as the adequacy of the going concern disclosures.

The following sample report language may be used as an emphasis-of-matter paragraph regarding going concern due to conditions caused by the COVID-19 pandemic when the entity is required under the applicable financial reporting framework to include a statement in the notes to the financial statements that substantial doubt exists:

> The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has been required by governmental authorities to close a number of its locations as a result of the COVID-19 pandemic, and its suppliers and customers have also been impacted by those governmental restrictions. The closures have caused a material adverse effect on the Company's revenues, results of operations, and cash flows, including the Company's ability to meet its obligations when due; and the Company has stated that substantial doubt exists about the Company's ability to continue as a going concern. Management's evaluation of the events and conditions and management's plans regarding those matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our conclusion is not modified with respect to this matter.

The following sample report language may be used as an emphasis-of matter-paragraph regarding going concern due to conditions caused by the COVID-19 pandemic when the entity is *not* required under the applicable financial reporting framework to include a statement in the notes to the financial statements that substantial doubt exists:

> The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has been required by governmental authorities to close a number of its locations as a result of the COVID-19 pandemic, and its suppliers and customers have also been impacted by those governmental restrictions. The closures have caused a material adverse effect on the Company's revenues, results of operations, and cash flows, including the Company's ability to meet its obligations when due, which raises substantial doubt about the Company's ability to continue as a going concern. Management's evaluation of the events and conditions and management's plans regarding those matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our conclusion is not modified with respect to this matter.

Lawsuit Uncertainties

When an accountant becomes aware of pending or threatened litigation, GAAP requires the accountant to follow the guidance in FASB ASC 450, *Contingencies*, to evaluate whether the contingency leads to an adjustment to or disclosure in the financial statements. In some situations, it will be obvious that the client should accrue for a loss and, accordingly, it would not be appropriate to use an emphasis-of-matter paragraph if the client refuses to make the adjustments. (This would be a GAAP departure, and reporting in those circumstances is addressed earlier in this lesson.) However, if the client is unable to evaluate the outcome of threatened or pending litigation, an uncertainty exists. If the application of GAAP results in a note disclosure about the uncertain outcome of the lawsuit (either

because a liability is probable but not estimable, or because it is reasonably possible), the accountant may desire to emphasize such an uncertainty in an emphasis-of-matter paragraph to his or her report, similar to the following:

> The Company is currently named in a legal action alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counteraction, and preliminary hearings and discovery proceedings on both actions are in progress. The Company has determined that it is not possible to predict the eventual outcome of the legal actions but has determined that the resolution of the actions will not result in an adverse judgment that would materially affect the financial statements. Accordingly, the accompanying financial statements do not include any adjustments related to the legal action under Financial Accounting Standards Board (FASB) ASC 450, *Contingencies*.

Reporting on uncertainties was discussed earlier in this section.

Reporting When There Is a Correction of an Error

AR-C 90.08 (AR-C 90A.05) describes errors as mistakes in financial statements and the application of accounting principles. Such mistakes may be mathematical or clerical errors or inadequate disclosures.

Errors may involve accounting principles (e.g., using an accounting principle that is not in conformity with GAAP or applying a GAAP principle incorrectly) or may not involve accounting principles (e.g., a mathematical error in pricing inventories).

Accountants might discover errors in previously issued financial statements in a variety of ways. In one instance, accountants might discover such errors as a result of performing a compilation or review on financial statements of a subsequent period. In another scenario, the accountants might discover errors as a result of performing a higher level of service (review or audit) on financial statements that they have previously compiled. Typically, the review or audit procedures result in some adjustments to the previously issued statements. Regardless of how such errors are discovered, questions frequently arise about how accountants should handle such situations when they occur.

Guidance for predecessor and successor accountants who discover errors in previously issued financial statements was discussed earlier in this lesson. Guidance for continuing accountants is discussed in AR-C 90 (AR-C 90A). Though outside the scope of this course, the procedural requirements of the SSARS are summarized and discussed in *PPC's Guide to Compilation and Review Engagements*. The following paragraphs summarize the primary reporting requirements in review engagements.

The primary reporting guidance in AR-C 90.54–.58 (AR-C 90A.75–.78) may be summarized as follows:

a. If the effect on the financial statements and accountant's report of the subsequently discovered information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and the accountant's report. The reasons for the revision usually should be described in a note to the financial statements and referred to in the accountant's report in an emphasis-of-matter paragraph. Generally, only the most recently issued financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.

b. When issuance of financial statements for a subsequent period is imminent, so that disclosure is not delayed, appropriate disclosure of the revision can be made in such statements instead of reissuing the earlier statements.

c. When the effect on the financial statements of the subsequently discovered information cannot be promptly determined, the issuance of revised financial statements would be delayed. However, if it appears that the statements will need to be revised, persons known to be using or who are likely to use the financial statements should be notified by the client that the statements should not be used and that revised statements and, where applicable, the accountant's report will be issued as soon as practicable.

The authors believe accountants may follow the above requirements for compilation engagements.

When revised compiled or reviewed financial statements are issued, as discussed in item a. above, the authors believe the accountant should determine that the reasons for the revision are adequately described in a note to the financial statements. AR-C 90.55c (AR-C 90A.76c) indicates if the accountant's conclusion on the revised financial statements differs from the accountant's conclusion on the original financial statements, an emphasis-of-matter paragraph should be included in the accountant's report. SSARS No. 25 (AR-C 90.94) also requires the accountant to include an emphasis-of-matter paragraph in the accountant's review report when there are adjustments to correct a prior period material misstatement in previously issued financial statements.

When issuance of compiled or reviewed financial statements for a subsequent period is imminent, as discussed in item b. above, the authors believe the accountant should determine that disclosure of the reasons for revision is made in the subsequent financial statements; however, reference to such disclosure in the accountant's compilation or review report, although usual, is not required for review reports prior to implementing SSARS No. 25, and is not required for compilation reports both before and after implementing SSARS No. 25, if the reasons are adequately disclosed in the financial statements. If, however, the reasons for the revision are not adequately disclosed in the financial statements, that is considered a departure from the applicable financial reporting framework. In these cases, the accountant would modify the compilation or review report by adding a separate emphasis-of-matter paragraph describing the revision. For a review report after implementing SSARS No. 25, the accountant may judgmentally determine to issue a modified conclusion.

Issuing a Revised Report on Compiled Financial Statements That Omit Substantially All Disclosures. Obviously, if the revised financial statements are compiled statements that omit substantially all disclosures, they will not include a note describing the reasons for the revision (unless such a note is included as "SELECTED INFORMATION," discussed earlier in this lesson). If the revised statements omit disclosures, the addition of a paragraph describing the reasons for the revision is optional but not required. Unless, in the accountant's professional judgment, the omission of disclosures would mislead financial statement users, the standard paragraph discussed earlier in this lesson adequately informs users of the limitations of statements that omit substantially all disclosures.

Dating the Revised Report. AR-C 90.55a (AR-C 90A.76a) states that the accountant would look to AR-C 90.52 (AR-C 90A.73) on the dating of the auditor's report on revised financial statements that are issued to correct an error, as described in item a., above. That guidance allows the accountant to either dual-date the report or use a later date (presumably the issuance date of the revised report).

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 90.40 (AR-C 90A.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 audited or reviewed by the other accountants [AR-C 90.122 (AR-C 90A.79)]. 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. AR-C 80 (AR-C 80A) does not contain guidance for obtaining compilation reports from other accountants. The reason for this is that no assurances can be derived from compilation work performed by other accountants.

AR-C 90.123 (AR-C 90A.80) states that reference to the audit or review of the other accountants in the accountant's review report should not be made if the other accountant's audit or review report restricts the use of such report.

When other accountants have audited or reviewed a component of the reporting entity, the accountant of the reporting entity may assume responsibility for to the other accountant's review report on the component of the reporting entity. If the accountant of the reporting entity decides not to assume responsibility for the audit or review performed by the other accountant, the accountant of the reporting entity should make reference to the review or audit of the other accountant in the accountant's review report [AR-C 90.122 (AR-C 90.A79)]. According to AR-C 90.124 (AR-C 90A.81), regardless of whether the accountant decides to make reference to the review of other

accountants in the review report, the accountant should communicate with the other accountants and ascertain the following:

a. The other accountants are aware that the division, branch, subsidiary, or other investee financial statements that have been audited or reviewed are to be included in the financial statements on which the accountant will report and the accountant will rely upon the other accountants' report.

b. The other accountants are familiar with the applicable financial reporting framework and applicable professional standards (SSARS or GAAS) and will conduct the review or audit in accordance with such.

c. The other accountants understand the ethical requirements that pertain to the engagement, including the independence requirements.

d. Intercompany transactions and accounts will be reviewed for matters that might affect appropriate eliminations and matters affecting the uniformity of accounting practices among the components included in the financial statements will be reviewed.

If the component entity's financial statements and the reporting entity's financial statements are prepared using different financial reporting frameworks, the review report of the accountant of the reporting entity may reference the review or audit report of the component entity if both of the following are true— [AR-C 90.125 (AR-C 90A.82)]

a. The accountant of the reporting entity has determined that the measurement, recognition, presentation, and disclosure criteria applicable to all material items in the component's financial statements are similar to the criteria applicable to the material items in the reporting entity's financial statements in accordance with the financial reporting framework used by the reporting entity.

b. The accountant of the reporting entity has obtained sufficient appropriate review evidence to be used to evaluate the appropriateness of the adjustments needed to convert the component's financial statements to the financial reporting framework used by the reporting entity without having to assume responsibility for, or be involved in, the work of the other accountants.

Other Reporting Responsibilities

SSARS No. 25 (AR-C 90.97) states that an accountant may be asked to address other reporting responsibilities in addition to reporting on the financial statements. In such situations, those other reporting responsibilities should be addressed in a separate section in the accountant's review report, under the heading "Report on Other Legal and Regulatory Requirements," or another appropriate heading. This additional reporting responsibilities section should follow the section of the report titled, "Report on the Financial Statements."

Tax Returns

SSARS does not establish standards or procedures for preparing tax returns nor does it encompass reporting on financial presentations included in tax returns. Consequently, when the accountant is engaged to prepare a tax return, it is not necessary to attach a compilation (or review) report. Even if a copy of the return is supplied to a third party such as a banker, SSARS do not apply. However, if an accountant prepares financial statements on a tax basis based on the tax return, he or she applies the requirements of AR-C 70 (AR-C 70A) to such financial statements.

Information returns such as Form 990 *(Return of Organization Exempt from Income Tax)* and Form 5500 *(Return of Employee Benefit Plan)* are considered tax returns for purposes of the SSARS.

However, if the client requests the accountant to issue a compilation or review report on financial information included in a tax return, the accountant may agree to issue such a report if he or she complies with the applicable standards. However, the tax return would not be referred to in the accountant's report as a financial statement. The authors believe that a more conservative course to follow would be to use a transmittal letter and not attach a report to the tax return.

General Ledger Bound with Financial Statements

Providing computerized accounting services and compiled financial statements is a common engagement for many practitioners. In many such instances, the product delivered to the client takes the form of an accountant's compilation report, bound with the compiled financial statements and general ledger. The question frequently considered is, "What is the accountant's reporting obligation with regard to the general ledger?" Many accountants believe that the accountant has no reporting obligation with regard to the general ledger. Some accountants believe, on the other hand, that SSARS are applicable, and accordingly, the accountant needs to report on the general ledger (when bound with financial statements) as supplementary information. The authors, however, support the first viewpoint and believe that the general ledger is part of the accountant's accounting services and that the accountant has no reporting obligation with regard to the general ledger. The general ledger is not considered supplementary information and need not be reported on in accordance with AR-C 80 (AR-C 80A) and AR-C 90 (AR-C 90A).

Preliminary Financial Statement Drafts

Preliminary drafts of financial statements are frequently stamped "Preliminary" or "Draft" and provided to clients for their review before final issuance. As preliminary drafts, they are often provided without accountant's reports. SSARS does not address *draft financial statements*. However, Paragraph 3.07 of the AICPA Guide suggest that the accountant would label each page of the draft financial statements with words such as "Draft," "Preliminary Draft," "Draft—Subject to Change," or "Working Draft" in order to prevent any confusion.

Summary Financial Statements

AU-C 810 (AU-C 810B) defines summary financial statements as financial statements presented in less detail than complete financial statements that are intended to present financial position, results of operations, and cash flows. Summary financial statements may simply be complete financial statements that omit notes or, more typically, financial statements that omit notes and combine statement components.

Because the SSARS are silent on the issue of summary financial statements that combine statement components, the authors believe for the purposes of applying SSARS, summary financial statements that *combine financial statement components* are not considered financial statements. However, SSARS addresses summary financial statements that *do not combine components* (i.e., they are summary financial statements only because disclosures are omitted) and considers these summary statements to be financial statements.

However, before agreeing to prepare and present summary financial statements (financial statements that omit substantially all disclosures), the authors believe the accountant needs to consider whether the client appears to have a valid business reason for presenting summary statements. The accountant would not prepare summary financial statements if the accountant, in their professional judgment, believes such a presentation would mislead users. See the discussion of reporting on financial statements that omit substantially all disclosures earlier in this lesson.

Reporting in Initial Accounting Periods

SSARS do not explicitly address reporting on financial statements for initial accounting periods. The unique problem in reporting on financial statements in the first year of a company's operations is that the statements of income, stockholders' equity, and cash flows are for the initial period, i.e., for the period from inception to the normal year end. That period may be for 12 months or for a shorter period. The standard compilation or review report would indicate that the statements of income, stockholders' equity, and cash flows are for the initial period.

Financial statements for initial accounting periods also would normally include a statement of stockholders' equity rather than a statement of retained earnings because in the initial period there would be changes in the components of stockholders' equity, other than retained earnings, e.g., issuance of common stock.

Reporting on Companies in Liquidation

According to FASB ASC 205-30-25, an entity should prepare its financial statements using the liquidation basis of accounting when liquidation is imminent, which is when the following conditions are met:

a. the likelihood is remote that the entity will return from liquidation, and

b. either (1) a plan for liquidation is 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 (2) a plan for liquidation is being imposed by other forces (for example, involuntary bankruptcy).

When business entities in liquidation, or for which liquidation appears imminent, prepare their financial statements using the liquidation basis of accounting, assets are presented at estimated realizable amounts, and liabilities are presented at the amounts of cash expected to be paid. The liquidation basis of accounting is considered to be GAAP for those entities. The following differences in reporting are usually recognized:

a. A statement of net assets in liquidation is typically presented instead of a balance sheet.

b. A statement of changes in net assets in liquidation is typically presented instead of statements of income and retained earnings and cash flows.

c. FASB ASC 205-30-50 includes the required financial statement disclosures for financial statements prepared using the liquidation basis.

d. If the disclosures in item c. are not made in compiled financial statements that omit substantially all disclosures, a sentence generally would be added to the first paragraph of the accountant's report indicating that the liquidation basis has been used.

e. If comparative financial statements are presented with the prior year prepared on the GAAP basis for a going concern and the current year on the liquidation basis, the financial statements (or the accountant's compilation report if disclosures are omitted) need to disclose that the company has changed its basis of accounting to a liquidation basis. In those circumstances, the following financial statements may be presented, which should be appropriately identified in the accountant's compilation and review reports:

   (1) Balance Sheet for December 31, 20X1.

   (2) Statements of Income, Retained Earnings, and Cash Flows for the year ended December 31, 20X1, and Statements of Income, Retained Earnings, and Cash Flows for the period January 1, 20X2, to the date of stockholder approval of the plan of liquidation.

   (3) Statement of Net Assets in Liquidation as of December 31, 20X2, and a Statement of Changes in Net Assets in Liquidation from date of liquidation to December 31, 20X2.

Although an other-matter paragraph is not required by AR-C 80 (AR-C 80A), an other-matter paragraph is permitted if the accountant wishes to highlight the matter.

Reporting by Companies in Reorganization under the Bankruptcy Code

FASB ASC 852-10, *Reorganizations*, provides guidance for financial reporting by companies that have filed petitions with the bankruptcy court and expect to reorganize as going concerns under Chapter 11 of the United States Code. FASB ASC 852-10:

a. Prescribes the accounting by a company for events and transactions:

   (1) related to the Chapter 11 petition during the reorganization proceedings and

   (2) at the time the company emerges from bankruptcy.

b. Is not applicable to companies in liquidation under Chapter 7 of the Bankruptcy Code or under out-of-court workouts.

FASB ASC 852-10 recommends that all companies report the same way while reorganizing under Chapter 11, with the objective of reflecting their financial evolution. To do that, their financial statements should distinguish transactions and events that are directly associated with the reorganization from the operations of the ongoing business as it evolves (FASB ASC 852-10-45-2). FASB ASC 852-10-45-19 requires that, on emergence from Chapter 11, companies meeting specified criteria adopt fresh-start accounting. FASB ASC 825-10-45-29 describes how entities not meeting those criteria should report their liabilities.

Companies that emerge from Chapter 11 should adopt fresh-start accounting if the following two conditions exist (FASB ASC 852-10-45-19):

a. The reorganization value of the assets of the entity (before confirmation) is less than postpetition liabilities and allowed claims.

b. Holders of existing voting shares immediately before confirmation retain less than 50% of the voting shares of the emerging entity.

Companies that meet both these conditions will report assets and liabilities at their going concern (reorganization) values.

Financial Statements Submitted to a Court of Law (Performing Litigation Services)

Accountants are sometimes associated with unaudited financial statements that may be intended solely for use in a pending or potential formal legal proceeding before a court of law. Accountants engaged to perform services on such financial statements often questioned whether SSARS applied in these circumstances. AR-C 70.01 (AR-C 70A.01) states that SSARS do not apply to financial statements prepared to be submitted in conjunction with litigation services that involve pending or potential formal legal or regulatory proceedings. The authors believe that examples include when the—

a. Service consists of being an expert witness.

b. Service consists of being a *trier of fact* or acting on behalf of one.

c. Accountant's work is, under the rules of the proceedings, subject to detailed analysis and challenge by each party to the dispute.

d. Accountant is engaged by an attorney to do work that will be protected by the attorney's work-product privilege, and such work is not intended to be used for other purposes.

When providing litigation services such as these, the accountant should comply with ET 1.300.001, "General Standards," of the AICPA *Code of Professional Conduct*. However, if the accountant in connection with litigation support services is specifically engaged to submit financial statements in accordance with SSARS, SSARS would apply.

On many such engagements the accountant is asked to perform certain procedures or to make certain analyses of existing financial statements. These are normally "agreed-upon procedure" engagements, and the accountant would comply with AT-C 215, *Agreed-Upon Procedures Engagements*.

Break-even Financial Statements

Occasionally, companies may ask accountants to compile financial statements showing amounts, e.g., inventory, that result in no profit or loss for the period (break-even financial statements). Since break-even financial statements are not in accordance with GAAP, consideration is given to whether modification of the compilation report will adequately disclose the departure. If so, AR-C 80.29–.33 (AR-C 80A.29–.33) address the requirements for modification of the standard compilation report if financial statements include departures from the applicable financial reporting framework. In addition, the authors believe the accountant needs to evaluate whether, in the accountant's professional judgment, the departures would be misleading users of the financial statements and the propriety of issuing *any* report.)

Whether the break-even financial statements are historical financial statements or more commonly used to refer to *prospective (or pro forma)* financial statements that project the amount of sales required for total revenues to equal total costs, SSARS apply, and *PPC's Guide to Forecasts and Projects* and *PPC's Guide to Nontraditional Engagements* may be referred to for guidance.

Financial Statements for a Period Longer Than 12 Months

Although financial statements for a period longer than 12 months are not frequently prepared, they may be appropriate when an accountant is initially engaged to report on financial statements of a company that has been in existence for more than 12 months. An AICPA *Technical Question and Answer* at Q&A 9160.07 states that it is acceptable for an accountant to report on financial statements covering a period longer than 12 months provided (a) the title of the financial statements is descriptive of the period covered and (b) the accountant's report clearly indicates the period covered by the financial statements.

Reports on the Application of Requirements of an Applicable Financial Reporting Framework

Practitioners occasionally receive requests from nonclients about the application of the requirements of an applicable financial reporting framework to a particular transaction or new financial product. Such requests are often made by management when it wants another opinion about the accounting treatment for a transaction for which there is little consensus or precedent, or by investment bankers when they want an opinion on the accounting treatment of a new financial product. For example, management may be considering entering into a lease agreement for office space and, because of the complex terms of the transaction, it is not readily apparent whether the lease should be classified as a capital lease or an operating lease. If the authoritative literature does not address this specific type of transaction, and few analogies or precedents exist, management may seek a second opinion as to how the lease should be classified.

AU-C 915, *Reports on Application of Requirements of an Applicable Financial Reporting Framework*, provides guidance to accountants in such situations. AU-C 915 applies to an accountant that has not been engaged to report on an entity's financial statements but is requested by management (or persons who will advise management such as attorneys or bankers) to—

a. provide advice about the application of the requirements of an applicable financial reporting framework to a specific transaction, or

b. provide advice about the type of report to be issued on its financial statements.

AU-C 915 is discussed in more detail in *PPC's Guide to Auditor's Reports*.

Reviewing Financial Statements of an Issuer

Generally, AR-C 90 (AR-C 90A) applies only to unaudited financial statements of nonpublic entities. An exception applies, however, when the annual financial statements of an issuer are not audited. In that situation, if the issuer's interim or annual financial statements are to be reviewed, the review should be performed in accordance with AR-C 90 (AR-C 90A). That situation occurs when federal and state securities laws allow an exemption from the requirement for audited financial statements.

Federal Securities Laws. For entities raising no more than $5 million from the sale of securities during a 12-month period, federal securities laws allow an exemption from the requirement to submit audited financial statements.

State Securities Laws. A number of states have *small offering* provisions that allow the use of AR-C 90 (AR-C 90A) reviewed financial statements in lieu of audited financial statements if certain conditions are met.

Increased Risk. While audited financial statements are not required in the preceding situations, they are not prohibited. Accountants should carefully consider the increased risk associated with the financial statements of issuers before agreeing to perform the limited procedures and provide the limited assurance of a review in accordance with AR-C 90 (AR-C 90A).

Interim Information in Notes to Audited Financial Statements

In some instances, nonpublic entities may elect to include interim financial information in the notes to audited financial statements. In those cases, auditors look to AU-C 930 for guidance rather than to SSARS.

Reporting on Consolidated or Combined Financial Statements

The accountant's standard compilation or review reports are appropriate whether the financial statements are those of a single entity such as a corporation or a partnership; a consolidated group of corporations; a combined group of affiliated companies; or a segment of any of those. Minor modifications need to be made to the standard report when reporting on consolidated or combined financial statements.

Reporting on Subsidiaries, Branches, Divisions, or Affiliates

Accountants frequently compile or review the separate financial statements of entities that are directly or indirectly owned or controlled by another company or are under common control with another company. Examples are subsidiaries, branches, or divisions of a "parent company," "sister companies" under common control with another company, or a company jointly controlled by other companies.

The standard report on separate financial statements of a subsidiary, branch, or division is essentially identical to the accountant's standard compilation or review report, except that the company's status (for example, a subsidiary or branch) generally is disclosed in the report. The disclosure may be made parenthetically after the name of the company in the first paragraph such as, "ABC Company (a division of DEF Company)" or "ABC Company (a wholly owned subsidiary of DEF Company)," in other appropriate captions, or in the notes to the financial statements. The disclosure might be combined with the disclosure of the type of legal entity, e.g., "ABC Company (a Texas corporation and wholly owned subsidiary of DEF Company)." Minor modifications need to be made to the standard report when reporting on consolidated or combined financial statements.

Supplementary Information Presented for Periods Prior to Those of the Financial Statements

Occasionally, accountants may be asked to report on supplementary information relating to periods prior to those for which basic financial statements are presented. For example, the client may request selected trends data for the years 20X1 through 20X5 in addition to the financial statements for the years 20X4 and 20X5. Neither the SSARS, nor the auditing standards specifies the type of report to be provided on the data for the earlier years, that is, for the years 20X1 through 20X3.

In those circumstances, the authors believe that accountants may report at the same level of service reported on originally on the data for earlier periods as they give on the data for the years covered by the basic financial statements.

Restricting the Use of a Report

AR-C 90.103–.104 (AR-C 90A.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 90.103–.104 (AR-C 90A.61–.62) indicate that the use of the accountant's 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. Prior to the implementation of SSARS No. 25, AR-C 90A.44 states 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 90A.61. After the implementation of SSARS No. 25, AR-C 90.81 states that such a paragraph should be included in the accountant's review report on special purpose financial statements prepared in accordance with the contractual basis of basis of accounting. AR-C 80 (AR-C 80A) does not address restricted use reports. However, Paragraph 2.79 of the AICPA Guide indicates that, although not required, accountants are not precluded from added a separate paragraph to the compilation report that restricts its use.

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. The authors 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, the authors recommend that the accountant obtain affirmative acknowledgement, 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 parties listed or the accountant may provide a written acknowledgement 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 acknowledgement is made to management, it should state that no procedures have been performed subsequent to the date of the report [AR-C 90.105–.106 (AR-C 90A.63–.64)].

According to AR-C 90.103–.104 (AR-C 90A.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, and (c) state that the report is not intended to be and should not be used by anyone other than the specified parties. The following sample report language would be used as the last paragraph in the restricted use accountant's report:

> 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.

Note that the report language restricts the use, not the distribution, of the report. Because of the reasons described above, 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.

Variable Interest Entities Reporting Considerations

For a variety of reasons, some reporting entities choose not to consider the impact of GAAP for Variable Interest Entities (VIEs) on their financial statements, instruct their accountants and auditors to disregard its impact, or otherwise search for alternatives to consolidation. This section provides a brief overview of reporting considerations for practitioners in compilation and review engagements who encounter such situations. This section is applicable only when reporting entities choose not to, or are not able to, apply the accounting alternative.

Reporting when there is a scope limitation, reporting when there is a departure from generally accepted accounting principles, and alternative reporting considerations are discussed in the remainder of this section.

Scope Limitations. Generally in a compilation or review engagement, a scope limitation exists when an accountant is unable to perform the procedures he or she considers necessary in the circumstances. Scope limitations may be imposed by the client, such as when the client limits or denies the accountant access to information, or by other circumstances, such as when accounting records are inadequate or due to the timing of the engagement. Scope limitations were discussed in detail earlier in this lesson.

However, according to Q&A 9150.29, management's refusal to assess whether the reporting entity is a primary beneficiary of a variable interest entity or to allow the accountant to perform the assessment is not considered a scope limitation in a compilation or review engagement. Instead, it is considered a GAAP departure.

GAAP Departures. Generally accepted accounting principles (GAAP) apply to all financial statements (unless they are prepared on a special purpose framework, such as the tax basis.) This section discusses reporting considerations when an entity's financial statements include a material departure from GAAP because of the entity's decision not to consolidate a variable interest entity for which it is the primary beneficiary.

If an entity knows that consolidation is required, but decides not to do so, a departure from GAAP exists. This often occurs for monthly or quarterly compilations or reviews when an entity chooses to consolidate for the year-end financial statements, but not for the interim financial statements. An accountant who becomes aware of a material departure from GAAP has several possible courses of action:

a. Persuade the client to revise the statements to conform with GAAP;

b. Refer to the departure in the report;

c. After implementing SSARS No. 25, for review reports, issue an "Adverse Conclusion"; or

d. Withdraw from the engagement.

If modification of the accountant's report is appropriate, the nature of the departure from GAAP should be disclosed in a separate other-matter paragraph, and the effects of the departure, if known, should be disclosed [AR-C 90.91 (AR-C 90A.57)]. If the effects are not known, accountants are not required to determine them, but they should state in their report that no determination of the effects of the departure has been made. Prior to implementing SSARS No. 25, an adverse report is not appropriate in a compilation or review engagement. However, accountants may wish to emphasize the limitations of financial statements having significant GAAP departures in a separate explanatory paragraph in the report in addition to the separate paragraph that describes the GAAP departure. SSARS No. 25 allows the accountant to express an adverse conclusion in a review engagement when the financial statements are materially and pervasively misstated (however, an adverse compilation report is still not appropriate).

Effect on Engagement When an Assessment Is Not Made. A *Technical Question and Answer* at Q&A 9150.29, *Effects on Compilation and Review Engagements When Management Does Not Assess Whether the Reporting Entity is the Primary Beneficiary of a Variable Interest Entity and Instructs the Accountant to Not Perform the Assessment*, states that FASB ASC 810-10-25-38A requires the reporting entity with a variable interest in a variable interest entity to assess whether the reporting entity is the primary beneficiary of the variable interest entity.

The Q&A addresses reporting considerations in compilation and review engagements in which the reporting entity does not make the assessment discussed in FASB ASC 810-10-25-38A and instructs the accountant not to make the assessment. The Q&A concludes that constitutes a departure from generally accepted accounting principles.

Following the nonauthoritative guidance in the Q&A, if the accountant concludes that modification of the standard compilation or review report for this GAAP departure is appropriate, the accountant would follow the guidance on GAAP departures earlier in this lesson and disclose the departure in a separate paragraph of the report. Such a paragraph may read as follows—

> Accounting principles generally accepted in the United States of America require management to assess whether the Company has a controlling interest in any entities to which the Company has a variable interest in order to determine if those entities should be consolidated. Management has not performed the required assessment and, therefore, if there are variable interest entities for which the Company is the primary beneficiary, has not consolidated those entities. Although the effects on the financial statements of the failure to perform the required assessment have not been determined, many elements in the financial statements would have been materially affected had management determined that the Company is the primary beneficiary of any variable interest entities.

If the accountant does not conclude that modification of the accountants' report is appropriate as such modification would not adequately convey the deficiencies in the financial statements, the accountant should withdraw from the engagement (AR-C 90A.59).

Many accountants, however, believe that despite the guidance in the Q&A, the failure to assess whether the reporting entity is the primary beneficiary of a VIE in a compilation or review is not a departure from GAAP. In an audit, the failure to perform such an assessment is a scope limitation, not a GAAP departure. They do not understand how the accountant can determine a departure has occurred if they do not even know that consolidation needs to occur. In addition, these same accountants believe that for small and midsize nonpublic entities the assessments are generally not difficult to make.

Alternative Reporting Considerations. Some reporting entities have considered—as alternatives to the consolidation of variable interest entities—parent-company financial statements, combined financial statements, or special purpose financial statements. This section discusses those matters.

Parent-entity Financial Statements. Some accountants have questioned whether a reporting entity could issue financial statements as a parent company, typically referred to as parent-entity financial statements, instead of consolidating. FASB ASC 810-10-45-11 states, "In some cases parent-entity statements may be needed, in addition to consolidated statements, to indicate adequately the position of bondholders and other creditors or preferred stockholders of the parent." In addition, the guidance in FASB ASC 810-10-45-11, further states that consolidated financial statements are the general-purpose financial statements of companies having one or more subsidiaries; thus, parent-entity statements are not a valid substitute for consolidated financial statements.

An AICPA *Technical Question and Answer* (Q&A 1400.32) addresses parent-entity financial statements and also concludes, consistent with the prior discussion, that such financial statements cannot be issued in lieu of consolidated financial statements.

Combined Financial Statements. As an alternative to consolidation in accordance with FASB ASC 810-10, some reporting entities have considered issuing combined financial statements instead of consolidated financial statements. Combined financial statements are addressed in FASB ASC 810-10-55-1B, which states, "There are circumstances, however, in which combined financial statements (as distinguished from consolidated statements) of commonly controlled entities are likely to be more meaningful than their separate financial statements." That paragraph indicates that it might be more meaningful to use combined financial statements for (a) two or more companies that are related in their operations and are controlled by the same individual, (b) a group of unconsolidated subsidiaries, or (c) companies under common management.

According to an AICPA *Technical Question and Answer* (Q&A 1400.29), it is not appropriate for a reporting entity that is the primary beneficiary of a VIE to issue combined, rather than consolidated, financial statements. However, the Q&A indicates GAAP permits combined financial statements when consolidated financial statements are not required. As a practical matter, there are usually no substantive differences between presenting consolidated or combined financial statements of commonly-controlled small or midsize nonpublic entity.

Tax Basis Financial Statements. Some reporting entities have chosen to issue financial statements prepared on the income tax basis of accounting as an alternative to consolidation in accordance with FASB ASC 810-10. The income tax basis of accounting is the basis of accounting that a reporting entity uses, or expects to use, to file its income tax return for the period covered by the financial statements and is considered a special purpose framework.

FASB ASC 810-10's consolidation requirements do not apply to financial statements prepared using the income tax basis of accounting since consolidation for tax-basis financial statements is based on the Internal Revenue Code. However, an entity that issues financial statements prepared in conformity with the income tax basis of accounting may be required to make certain disclosures required by GAAP for VIEs. Essentially, if the special purpose framework financial statements include elements, accounts, or items which would require disclosure in financial statements prepared in accordance with GAAP, the statements should either provide the relevant disclosure or present information that communicates the substance of the disclosure.

Private Company Council Alternatives. According to Q&A 9150.32, an accountant is not required to add an emphasis-of-matter (EOM) paragraph to his or her compilation or review report when a client who has adopted one

or more of the Private Company Council (PCC) accounting alternatives in the current year has disclosed the change in accounting principle in the financial statements. (Disclosure is only required if the change is material to the financial statements.) However, AR-C 80 (AR-C 80A) and AR-C 90 (AR-C 90A) do not prohibit the accountant from choosing to include an EOM paragraph about the change in accounting principle.

According to Q&A 9150.33, when a private company client has adopted one or more of the PCC accounting alternatives in the current year and refuses to include the related disclosures (if material to the financial statements and if management has not elected to omit substantially all disclosures for the compilation), then the accountant should treat the omission as a departure from the applicable financial reporting framework.

SELF-STUDY QUIZ

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

18. Which of the following terms refers to when an accountant provides different levels of assurance on a single set of financial statements?

    a. Reporting on uncertainties.

    b. An other-matter paragraph.

    c. A modified conclusion.

    d. Split-level reporting.

19. Under which of the following circumstances might an accountant choose to add an emphasis-of-matter or other-matter paragraph to a compilation or review report when it is not required?

    a. An uncertainty exists about the outcome of important litigation.

    b. The financial statements were prepared in accordance with a special purpose framework.

    c. Partnership statements omit substantially all disclosures.

    d. Required supplementary information has been included with the financial statements and the related report.

20. Emphasis-of-matter and other-matter paragraphs should—

    a. Have a title in both compilation and review reports.

    b. Be placed immediately after the introductory paragraph of the report.

    c. Indicate how the matter discussed modifies the accountant's conclusion.

    d. Include a reference to the matter emphasized and where relevant disclosures can be found.

21. Katie is engaged to review Quills & Ink (Q&I). Q&I has a component division that will be reviewed by a different accountant. Katie decides to reference the other reviewer's report in her review report. Katie will need to communicate with the other accountant about all of the following **except**:

    a. Whether that accountant knows Katie will rely on his or her report.

    b. Whether that accountant will conduct his or her review in accordance with the SSARS.

    c. Whether that accountant understands all the ethical requirements that affect the engagement.

    d. Whether that accountant will leave the review of intercompany accounts to Katie.

22. Which of the following is one of the conditions that should be met for a company to use fresh-start accounting after emerging from Chapter 11 bankruptcy?

    a. The value of the assets after reorganization is the same amount or more than postpetition liabilities and allowed claims.

    b. Shareholders before confirmation retain less than 50% of the emerging entity's voting shares.

    c. The company presents its financial statements using the income tax basis of accounting.

    d. The company has already completed its liquidation under Chapter 7 of the Bankruptcy Code.

23. Which of the following guidance applies when restricting the use of a report in a compilation or review engagement?

    a. Restricted-use reports are intended only for management and those charged with governance.

    b. Reports should only be restricted if required by professional standards.

    c. If worded properly, both the use and the distribution of a restricted report should be affected.

    d. If the accountant issues a report the covers restricted and nonrestricted information, the whole report should be restricted.

24. Which of the following statements best describe an issue related to reporting considerations for variable interest entities (VIEs) in compilation and review engagements?

    a. A scope limitation occurs if management refuses to assess or allow the accountant to assess whether the reporting entity is a primary beneficiary of a VIE.

    b. Instead of consolidating its financial statements to account for a VIE, the reporting entity can choose to issue its financial statements as a parent company.

    c. If the entity adopted accounting alternatives from the Private Company Council, the accountant can choose to highlight this in an emphasis-of-matter paragraph.

    d. If the entity issues its financial statements on the income tax basis, any VIEs will need to be consolidated.

SELF-STUDY ANSWERS

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

18. Which of the following terms refers to when an accountant provides different levels of assurance on a single set of financial statements? **(Page 240)**

    a. Reporting on uncertainties. [This answer is incorrect. Uncertainties include, but are not limited to, contingencies covered by FASB ASC 450 and matters related to estimates covered by FASB ASC 275-10. Examples include tax claims with unclear precedents and contracts in dispute. However, this is unrelated to the term requested in this question.]

    b. An other-matter paragraph. [This answer is incorrect. An *other-matter paragraph* refers to a matter other than those presented or disclosed in the financial statements that is required by the SSARS or, in the accountant's professional judgment, is important to the users' understanding of the review, the accountant's responsibilities, or the accountant's compilation or review report. However, this is a separate issue from the term requested in this question.]

    c. A modified conclusion. [This answer is incorrect. After implementing SSARS No. 25, departures from the applicable financial reporting framework result in a modified conclusion. However, providing different levels of assurance on a single set of statement is not related to reporting on departures.]

    d. **Split-level reporting. [This answer is correct. *Split-level reporting* involves providing different levels of assurance on a single set of financial statements (for example, auditing the balance sheet and reviewing the income statement). Authoritative literature does not address whether an accountant can audit a balance sheet and review an income statement for the same set of financial statements. However, this course suggests that an accountant may wish to avoid an engagement involving an audit of one statement and a review of another statement.]**

19. Under which of the following circumstances might an accountant choose to add an emphasis-of-matter or other-matter paragraph to a compilation or review report when it is not required? **(Page 243)**

    a. **An uncertainty exists about the outcome of important litigation. [This answer is correct. In addition to the required additional, emphasis-of-matter, and other-matter paragraphs, there are situations in which accountants may consider it necessary and choose to add such a paragraph. Examples include an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time in a compilation, an uncertainty relating to the future outcome of unusually important litigation or regulatory action, or a major catastrophe that will have a significant effect on the entity's financial position.]**

    b. The financial statements were prepared in accordance with a special purpose framework. [This answer is incorrect. When the financial statements are prepared in accordance with a special purpose framework, AR-C 80.21 (AR-C 80A.21) requires accountants to add an additional paragraph to a compilation report. However, AR-C 90.80 (AR-C 90A.43) requires this information to be added to a review report as an emphasis-of-matter paragraph.]

    c. Partnership statements omit substantially all disclosures. [This answer is incorrect. Some practitioners include an other-mater paragraph in their compilation report on financial statements that omit substantially all disclosures to explain why there is no tax provision in the financial statements for a partnership or S corporation. This course, however, suggests that in a non-disclosure compilation report this other-matter paragraph is not needed and, in fact, should not be included. Therefore, even though technically accountants could choose to add this type of paragraph, there is a better answer choice to this question.]

    d. Required supplementary information has been included with the financial statements and the related report. [This answer is incorrect. Per AR-C 80.37–.39 (AR-C 80A.37–.39), when required supplementary information is included with the financial statements and the accountant's compilation report, the

report should include an other-matter paragraph. AR-C 90.129–.131 (AR-C 90A.86–.88) requires the same for a review report.]

20. Emphasis-of-matter and other-matter paragraphs should— **(Page 244)**

    a. Have a title in both compilation and review reports. [This answer is incorrect. In a review report, such paragraphs should have an appropriate heading (e.g., "Emphasis of a Matter" or "Other Matter"), but in a compilation report, the use of headings is optional.]

    b. Be placed immediately after the introductory paragraph of the report. [This answer is incorrect. Such paragraphs should be immediately after the accountant's conclusion paragraph in the accountant's review report prior to implementing SSARS No. 25 (AR-C 90A.53a). SSARS No. 25 (AR-C 90.89) does not prescribe a placement for the emphasis-of-matter paragraph or other matter paragraph in review reports. No placement is prescribed before or after implementing SSARS No. 25 in a compilation report.]

    c. Indicate how the matter discussed modifies the accountant's conclusion. [This answer is incorrect. In a review report, such paragraphs should 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.]

    d. **Include a reference to the matter emphasized and where relevant disclosures can be found. [This answer is correct. Per AR-C 90.90–.92 (AR-C 90A.53–.54), such paragraphs should 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.]**

21. Katie is engaged to review Quills & Ink (Q&I). Q&I has a component division that will be reviewed by a different accountant. Katie decides to reference the other reviewer's report in her review report. Katie will need to communicate with the other accountant about all of the following **except**: **(Page 248)**

    a. Whether that accountant knows Katie will rely on his or her report. [This answer is incorrect. According to AR-C 90.124 (AR-C 90A.81), Katie needs to ascertain whether the other accountant is aware that the division's financial statements are to be included in the financial statements on which Katie will report and that Katie will rely on the other accountant's report.]

    b. Whether that accountant will conduct his or her review in accordance with the SSARS. [This answer is incorrect. As outlined in AR-C 90.124 (AR-C 90A.81), Katie needs to find out whether the other accountant is familiar with the applicable financial reporting framework and applicable professional standards (SSARS or GAAS) and will conduct the review in accordance with them.]

    c. Whether that accountant understands all the ethical requirements that affect the engagement. [This answer is incorrect. Per AR-C 90.124 (AR-C 90A.81), Katie needs to determine whether the other accountant understands the ethical requirements that pertain to the engagement, including the independence requirements.]

    d. **Whether that accountant will leave the review of intercompany accounts to Katie. [This answer is correct. This is not one of the communication items listed in AR-C 90.124 (AR-C 90A.81). Instead, Katie needs to determine whether intercompany transactions and accounts will be reviewed for matters that might affect appropriate eliminations and matters affecting the uniformity of accounting practices among the components included in the financial statements will be reviewed.]**

22. Which of the following is one of the conditions that should be met for a company to use fresh-start accounting after emerging from Chapter 11 bankruptcy? **(Page 252)**

    a. The value of the assets after reorganization is the same amount or more than postpetition liabilities and allowed claims. [This answer is incorrect. Per FASB ASC 852-10-45-19, fresh-start accounting can be adopted if, among other things, the reorganization value of the assets of the entity (before confirmation) is *less than* postpetition liabilities and allowed claims.]

b. **Shareholders before confirmation retain less than 50% of the emerging entity's voting shares. [This answer is correct. According to FASB ASC 852-10-45-19, companies that emerge from Chapter 11 should adopt fresh-start accounting if two conditions exist. One of those conditions is that holders of existing voting shares immediately before confirmation retain less than 50% of the voting shares of the emerging entity. If both of the conditions are met, the company will report assets and liabilities at their going concern (reorganization) values.]**

c. The company presents its financial statements using the income tax basis of accounting. [This answer is incorrect. FASB ASC 852-10 recommends that all companies report the same way while reorganizing under Chapter 11, with the objective of reflecting their financial evolution. However, this does not involve the income tax basis of accounting. Instead, such companies' financial statements should distinguish transactions and events that are directly associated with the reorganization from the operations of the ongoing business as it evolves.]

d. The company has already completed its liquidation under Chapter 7 of the Bankruptcy Code. [This answer is incorrect. Per FASB ASC 852-10, Chapter 11 of the Bankruptcy Code is not applicable to companies in liquidation under Chapter 7 of that code or under out-of-court workouts. Therefore, when Chapter 7 is involved, the company will not re-emerge and use this type of fresh-start accounting.]

23. Which of the following guidance applies when restricting the use of a report in a compilation or review engagement? **(Page 255)**

a. Restricted-use reports are intended only for management and those charged with governance. [This answer is incorrect. *Restricted-use* reports are intended only for one or more specified third parties. All other reports are considered to be *general-use* reports.]

b. Reports should only be restricted if required by professional standards. [This answer is incorrect. Some CPAs have asked 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.]

c. If worded properly, both the use and the distribution of a restricted report should be affected. [This answer is incorrect. Report language restricts the use, not the distribution, of the report. 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.]

d. **If the accountant issues a report the covers restricted and nonrestricted information, the whole report should be restricted. [This answer is correct. 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, unless required by law to do otherwise.]**

24. Which of the following statements best describe an issue related to reporting considerations for variable interest entities (VIEs) in compilation and review engagements? **(Page 257)**

a. A scope limitation occurs if management refuses to assess or allow the accountant to assess whether the reporting entity is a primary beneficiary of a VIE. [This answer is incorrect. According to Q&A 9150.29, management's refusal to assess whether the reporting entity is a primary beneficiary of a VIE or to allow the accountant to perform the assessment is *not* considered a scope limitation in a compilation or review engagement. Instead, it is considered a GAAP departure.]

b. Instead of consolidating its financial statements to account for a VIE, the reporting entity can choose to issue its financial statements as a parent company. [This answer is incorrect. Some accountants have questioned whether a reporting entity could issue financial statements as a parent company instead of consolidating. According to the guidance in FASB ASC 810-10-45-11 and Q&A 1400.32,

however, it is not appropriate to issue parent-entity statements in lieu of consolidated financial statements.]

c. **If the entity adopted accounting alternatives from the Private Company Council, the accountant can choose to highlight this in an emphasis-of-matter paragraph. [This answer is correct. According to Q&A 9150.32, an accountant is not required to add an emphasis-of-matter paragraph to his or her compilation or review report when a client who has adopted one or more of the Private Company Council (PCC) accounting alternatives in the current year has disclosed the change in accounting principle in the financial statements. However, AR-C 80 (AR-C 80A) and AR-C 90 (AR-C 90A) do not prohibit the accountant from choosing to include such a paragraph about the change in accounting principle.]**

d. If the entity issues its financial statements on the income tax basis, any VIEs will need to be consolidated. [This answer is incorrect. FASB ASC 810-10's consolidation requirements do *not* apply to financial statements prepared using the income tax basis of accounting since consolidation for tax-basis financial statements is based on the Internal Revenue Code. However, an entity that issues financial statements prepared in conformity with the income tax basis of accounting may be required to make certain disclosures required by GAAP for VIEs.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Compilation and Review Engagements—Course 2—Review Procedures and Reporting on Compiled or Reviewed Financial Statements (CARTG212)

Testing Instructions

1. Following these instructions is an **Examination for CPE Credit** consisting of multiple choice questions. 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 those 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 the PDF and can be printed if needed.

2. **ONLINE GRADING.** Log onto our Online Grading Center at **cl.tr.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $109 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

3. **PRINT GRADING.** If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($109 for email or fax; $119 for regular mail). The answer sheet is found at the end of the **Examination for CPE Credit**. Answer sheets may be printed from the PDF; they can also be scanned to send via email, if desired. Each answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for the course. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

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

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

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     CARTG212 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

   If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

4. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($109 for answer sheets sent by email or fax; $119 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three

courses, the price for grading all three is $310 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $392 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $463 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

5. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **July 31, 2022**. CPE credit will be given for examination scores of 70% or higher.

6. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** and the **Self-study Course Evaluation** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy of the answer sheet for your records.

7. Please direct any questions or comments to our Customer Service department at (800) 431-9025 (Option 2).

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Compilation and Review Engagements—Course 2—Review Procedures and Reporting on Compiled or Reviewed Financial Statements (CARTG212)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet is located at the end of the exam and can be printed out, if desired. Alternatively, it can be accessed by logging onto the Online Grading System.

1. What level of knowledge does an accountant need to have about a client's industry to perform a review engagement?

    a. The accountant should be an expert in the industry.

    b. The accountant should have experience in the industry.

    c. The accountant should be familiar with the industry's unique principles and practices.

    d. The accountant does not need knowledge about the industry since reviews have a more limited scope than audit engagements.

2. When are accountants required to use analytical procedures during a review engagement?

    a. For engagement planning.

    b. For final review.

    c. As substantive procedures.

    d. When gathering review evidence.

3. After implementing SSARS No. 25, which of the following statements best describes the inquiries an accountant makes during a review engagement?

    a. The accountant is required to make a certain number of inquiries and that is all they are allowed to ask about.

    b. The accountant must make certain required inquiries, but additional inquiries are also allowed.

    c. The accountant can consider making inquiries suggested by professional guidance, but ultimately the inquiries are based on the individual engagement.

    d. Guidance does not provide a list of inquiries, so the accountant is responsible for determining which inquires will be made and to whom.

4. Which of the following guidance might be helpful when selecting appropriate analytical procedures for a review engagement?

    a. Make sure all inquiries are supplemented by an analytical procedure for sufficient assurance.

    b. Consider using inquiries instead of analytical procedures for accounts that required adjustments in prior years.

    c. Trend analysis is most effective and useful for analyzing income statement accounts.

    d. Analytical procedures are standardized and do not vary from engagement to engagement.

5. Why is it critical for accountants to develop expectations when performing analytical procedures?

    a. Expectations represent the accountant's prediction of recorded amounts or the ratios developed from such amounts.

    b. Expectations are identified by identifying implausible relationships between accounts and ruling them out.

    c. Differences from expectations are typically written off as they are seldom important to the financial statements.

    d. Developing expectations must be done independently of the client's industry so that the review is impartial.

6. How many expectations should an accountant typically develop for one account?

    a. One.

    b. Two.

    c. Five.

    d. Twenty.

7. In a review engagement, if the applicable financial framework requires management to evaluate the entity's ability to continue as a going concern for a reasonable period of time, the accountant is required to perform procedures that do all of the following **except**:

    a. Determine whether the going concern basis of accounting is appropriate.

    b. Assess management plans to mitigate any doubts as to the ability to continue as a going concern.

    c. Identify conditions or events that raise substantial doubt about the entity's ability to continue as a going concern.

    d. Determine the adequacy of the entity's related financial statement disclosures.

8. Which of the following statements best describes an aspect of an accountant's communication of significant matters to management in a review engagement?

    a. The communication to management must be written, not oral.

    b. Communications about fraud or noncompliance must be documented.

    c. Such communications should be withheld until the end of the engagement.

    d. The only required communications are those related to fraud.

9. How will accountants address materiality in a review engagement after implementing SSARS No. 25 (AR-C 90.19–.20)?

    a. SSARS No. 25 will eliminate the requirement for accountants to document materiality.

    b. Accountants will no longer be required to apply materiality in designing procedures.

    c. SSARS No. 25 will specifically require accountants to determine and document materiality.

    d. Addressing materiality in a review engagement is not required and would be considered unnecessary work on the part of the accountant.

10. Pansy accepts an engagement to review the financial statements of MagiCorp. She prepares a representation letter, but management refuses to sign it or to provide a different one. How will this affect Pansy's report?

    a. Pansy should issue a review report but note management's refusal in an other-matter paragraph.

    b. Pansy should step down the report and issue a compilation report instead of a review report.

    c. Pansy should issue the type of report that best fits the individual facts and circumstances of the engagement.

    d. Pansy should resign from the engagement without issuing a report as the financial statements may be misleading.

11. Under the SSARS, when can an accountant utilize the non-reporting option under AR-C 70 (AR-C 70A)?

    a. When the accountant performs a compilation engagement.

    b. When the accountant performs a review engagement.

    c. When the accountant is engaged to prepare financial statements, except in limited circumstances.

    d. When the financial statements are prepared in accordance with International Financial Reporting Standards (IFRS).

12. Under the SSARS, a compilation report should do which of the following?

    a. Refer to other procedures that the accountant may have performed in addition to traditional compilation procedures.

    b. Include a statement that the accountant takes responsibility for the financial statements being compiled.

    c. Specify the date by which the compilation report will be completed and delivered to management.

    d. Include a statement that the accountant, among other things, does not express an opinion on the financial statements.

13. What is one way that a compilation report might be differentiated from a review report?

    a. It may be only one paragraph.

    b. It has a specific title.

    c. It provides assurance on only certain aspects of the financial statements.

    d. It mentions compilation procedures that should be listed in the next review report.

14. Is it permissible for an accountant to perform different levels of services on financial statements from the same period?

    a. Yes, it would always be acceptable.

    b. Yes, it is permissible if the client has a valid business reason.

    c. Yes, it is permissible unless material departures from GAAP are found.

    d. No, this is prohibited under AR-C 80A.

15. What date should be used for a compilation report?

    a. The date analytical procedures are complete.

    b. The date that inquiries are complete.

    c. The date the financial statements are read.

    d. Any date after that used for the management representation letter.

16. What type of report can an accountant issue if he or she is **not** independent?

    a. A compilation report only.

    b. A review report only.

    c. Either a compilation or a review report, if certain criteria or met.

    d. Both a compilation report and a review report would be prohibited.

17. Greg's review client omits comprehensive income from the financial statements. How should Greg proceed?

    a. He should withdraw from the review engagement.

    b. He should step the review down to a compilation.

    c. He should treat the omission as a departure in his report.

    d. He should modify the financial statements to include it.

18. When might an accountant want to include an other-matter paragraph in a review or compilation report that emphasizes the limitations of the financial statements?

    a. The financial statements omit the statement of cash flows and substantially all disclosures.

    b. The financial statements have significant GAAP departures.

    c. The accountant is not independent from the compilation or review client.

    d. The compilation or review client only presents one financial statement, such as a balance sheet.

19. When might an accountant provide a working trial balance to a client instead of a compilation or review report?

    a. The accountant lacks independence.

    b. There is a scope limitation.

    c. There is a material GAAP departure.

    d. The statements are included in a Consulting Services report.

20. Which of the following recommendations would be helpful when a client presents supplementary information along with its compiled or reviewed financial statements?

    a. Schedules that provide detail of line items in the basic financial statements should be considered part of the basic financial statements and not supplementary information.

    b. All supplementary information should be placed after the basic financial statements and the financial statement notes, preceded by an appropriate title page.

    c. Any supplementary information provided by the compilation or review client should be treated as if it is required supplementary information.

    d. Charts and graphs should be considered supplementary information if they meet the guidelines set down for graphic presentations in the SSARS.

21. Which of the following best describes an accountant's responsibility for required supplementary information included in compiled or reviewed financial statements?

    a. Compilation and review standards require an accountant to apply procedures to required supplementary information.

    b. The SSARS require an accountant to compile or review required supplementary information.

    c. If required supplementary information is not presented in accordance with the applicable financial reporting framework, the accountant must decline the engagement.

    d. The SSARS require an accountant to note the degree of responsibility he or she accepts for required supplementary information.

22. When financial statements of multiple periods are presented in columnar form, it is called what?

    a. An accounting change.

    b. Comparative financial statements.

    c. A Consulting Services (CS) report.

    d. Supplementary information.

23. Oliver is engaged to compile a set of comparative financial statements. The prior period financial statements were reviewed. How will this affect Oliver's engagement?

    a. Oliver should update the report on the prior period statements.

    b. Oliver can refer to the review report in his compilation report.

    c. Oliver should list all the procedures he performed on the reviewed statements.

    d. Oliver may reissue the report on the prior period using the current date.

24. When can comparative financial statements that omit substantially all disclosures be reported on by a CPA?

    a. When all of the periods presented have been reviewed.

    b. When the current period presented has been compiled.

    c. When at least one of the periods presented has been audited.

    d. When all of the periods presented have been compiled.

25. Which of the following statements correctly describes one way a change in accountants may be dealt with in compilation and review engagements?

    a. Predecessor auditors are required to reissue their reports when the statements they reported on are included in comparative financial statements.

    b. Unless additional information is obtained that changes the financial statements, the reissued report will keep the date of the original report.

    c. If the successor auditor compiles or reviews prior period financial statements, the reporting obligation will be less due to the predecessor's report.

    d. If the predecessor has ceased operations, more stringent requirements must be met if reference is made to the predecessor's report.

26. SSARS guidance is inappropriate for comparative financial statements if which of the following is true?

    a. The accountant determines that, due to a change, the prior period financial statements must be restated.

    b. The accountant's report is dual dated after the prior period financial statements are restated.

    c. The entity changes its status from nonpublic entity to issuer.

    d. The entity changes it status from issuer to nonpublic entity.

27. A change in depreciation method for a long-lived financial asset would be considered which of the following?

    a. A change in accounting estimate.

    b. A change in accounting principle.

    c. A change in reporting entity.

    d. An error correction.

28. Which of the following occurs when a compilation or review client has a change in accounting principle?

    a. The accountant must modify his or her compilation or review report.

    b. The change should be reported prospectively but not retrospectively.

    c. Indirect effects of the change must be factored in if the change is reported retrospectively.

    d. Management's justification for the change must be disclosed in the financial statements.

29. If an accountant prepares the financial statements for a nonprofit organization, how can the accountant report on those financial statements without violating the Yellow Book's independence rules?

    a. The accountant can perform the organization's annual audit.

    b. The accountant can compile the organization's financial statements.

    c. The accountant is required to perform nonaudit services instead.

    d. The accountant is prohibited from releasing any kind of report on the statements by the Yellow Book.

30. If a state government requires school districts to submit an annual report before its annual financial statement audit, the financial statements submitted with this report would typically be—

    a. audited.

    b. compiled.

    c. reviewed.

    d. client-prepared without an accountant's report.

31. Which of the following best describes a presentation of a specified element of a financial statement?

    a. Such elements can be audited, but they cannot be compiled or reviewed.

    b. Such elements can be compiled, but they cannot be audited or reviewed.

    c. Such elements can be audited, reviewed, or compiled as needed by the client.

    d. Such elements can only be addressed individually in an agreed-upon procedures engagement.

32. Based on the recommendations of this course, it is a best practice for accountants to avoid which of the following when performing compilation and review engagements?

    a. Reporting on compliance through a separate engagement.

    b. Reporting on audited financial statements.

    c. Split-level reporting.

    d. The use of other-matter paragraphs in compilation reports.

33. Which of the following is typically used to call attention to a matter presented in the financial statements that, based on the accountant's professional judgment, is important to the users' understanding of the financial statements or is required to be included by the SSARS?

    a. An additional paragraph.

    b. An emphasis-of-matter paragraph.

    c. An introductory paragraph.

    d. An other-matter paragraph.

34. Actions by governmental regulatory agencies and lawsuits for which the outcome cannot be determined are examples of what?

    a. Contractual agreements.

    b. Error corrections.

    c. Uncertainties.

    d. Variable interest entities (VIEs).

35. After implemention of SSARS No. 25, if proper disclosure about the entity's ability to continue as a going concern for a reasonable period is not made in the financial statements, how will this affect the accountant's review report?

    a. The accountant should add an other-matter paragraph.

    b. The accountant should follow the same guidance as for a lawsuit uncertainty.

    c. The accountant should express an unmodified conclusion.

    d. The accountant should express a modified conclusion.

36. Which of the following guidance applies when an accountant discovers an error in prior period financial statements during a compilation or review engagement?

    a. If the effect on the financial statements and the review report can be promptly determined, disclosure consists of issuing revised statements and the report as soon as possible.

    b. When issuance of the financial statements is imminent, it is unnecessary to either disclose or reissue the prior period statements or the review report in order to avoid delays.

    c. If the effect on the financial statements cannot be determined in a timely fashion, an interim review report can be issued until the final report reflecting the error is ready.

    d. The guidance for review reports is different from that for compilation reports, so accountants performing a compilation will need to address the issue in other ways.

37. Should accountants attach compilation or review reports when they are engaged to prepare tax returns?

    a. Yes, attaching a compilation or a review report is required for this type of engagement under SSARS.

    b. No, SSARS does not include standards for preparing tax returns, so neither a compilation nor a review report is necessary.

    c. No, providing either a compilation or a review report is prohibited under SSARS, and neither should accountants provide a transmittal letter.

    d. No, and if the client requests a compilation or review report over the information in the tax return, the accountant should decline the engagement.

38. What type of financial statements typically omit notes and combine financial statement components for a less detailed presentation?

    a. Break-even financial statements.

    b. Complete financial statements.

    c. Initial accounting period statements.

    d. Summary financial statements.

39. Which of the following is a condition that indicates use of the liquidation basis of accounting?

    a. It is likely that the business will reorganize and continue operation.

    b. The plan for liquidation has been suggested but not approved.

    c. A plan for liquidation is being imposed by other forces.

    d. The financial statements will be submitted to a court of law.

40. Can an accountant report on financial statements that cover more than 12 months?
    a. No, reporting on financial statements that cover more than 12 months is prohibited by SSARS.
    b. Yes, but when reporting on such statements, the length of time should be concealed.
    c. Yes, if the report and the title of the statements indicate the time period covered by the statements.
    d. No, such reporting is disallowed, but the accountant can perform an agreed-upon procedure instead.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Compilation and Review Engagements—Course 2—Review Procedures and Reporting on Compiled or Reviewed Financial Statements (CARTG212)

Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State/ZIP: _____

Firm Phone: _____ Firm Fax No.: _____

Firm Email: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answers for each question by filling in the appropriate circle as shown: Fill in like this: ● not like this: Ⓘ ⊗ ✓

You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

You may complete the exam online for $109 by logging onto our Online Grading Center at **cl.tr.com/ogs.** Alternatively, you may fax the completed Examination for CPE Credit Answer Sheet and Self-study Course Evaluation to Thomson Reuters (Tax & Accounting) Inc. at (888) 286-9070 or email it to *CPLGrading@thomsonreuters.com.* Mailing instructions are included in the Exam Instructions. Payment information must be included for all print grading. The price for emailed or faxed answer sheets is $109; the price for answer sheets sent by regular mail is $119.

Expiration Date: July 31, 2022

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Compilation and Review Engagements—Course 2—Review Procedures and Reporting on Compiled or Reviewed Financial Statements (CARTG212)

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. How would you rate the appropriateness of the course materials for your experience level?	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course content?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant, and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. _____

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can. (Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of this page. **Yes/No** ○ ○

For more information on our CPE & Training solutions, visit cl.tr.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____.

GLOSSARY

Accounting change: These are defined as (1) a *change in accounting estimate*, (2) a *change in reporting entity*, or (3) a *change in accounting principle*. The correction of an error in previously issued financial statements is not considered an accounting change.

Analytical procedures: In a review engagement, these assist the accountant in identifying relationships and individual items that appear unusual. They are required when performing the review procedures as part of gathering review evidence.

Break-even financial statements: Statements showing amounts (e.g., inventory) that result in no profit or loss for the period. Such statements are not in accordance with GAAP.

Change in accounting estimate: These result from additional information or new developments and do not require prior period adjustment. Examples include periodically changing estimated annual tax rates or allowances for bad debt, as well as changes in methods of depreciation, amortization, and depletion for long-lived financial assets.

Change in accounting principle: This is a change from one acceptable accounting principle to another or the change in the method of applying an acceptable accounting principle. Examples include changing how inventories are priced. Changing from an unacceptable method to an acceptable one is an error correction and not considered a change in accounting principle.

Change in reporting entity: This is a change that results in financial statements that are, in effect, the statements of a different reporting entity, such as changes in the companies or subsidiaries that are included in combined or consolidated financial statements. A change in the legal form of business is not considered a change in reporting entity.

Contractual basis of accounting: A basis of accounting an entity uses to comply with the terms of a contract with third parties. It is a *special purpose framework*.

Emphasis-of-matter paragraph: A paragraph added to a compilation or review report that calls attention to a matter presented or disclosed in the financial statements that, in the accountant's professional judgment, is important to the users' understanding of the financial statements or is required to be included by the SSARS.

Fair presentation framework: A financial reporting framework that complies with the requirements of the framework and either (1) acknowledges that it may be necessary for management to provide disclosures beyond those specifically required by the framework in order to achieve fair presentation or (2) acknowledges that in rare circumstances it may be necessary for management to depart from a framework requirement to achieve fair presentation of the financial statements.

Materiality: According to the Statement of Financial Accounting Concepts No. 8, this is the omission or misstatement of an item in the financial statements that is large enough or significant enough that it is probable a reasonable person relying on the information would change their judgment or would be influenced by the inclusion or correction of the item. It is entity specific.

Nonrecognized subsequent events: According to FASB ASC 855-10, these are subsequent events that relate to conditions that did not exist at the balance sheet date being reported on and, accordingly, do not result in adjustments to the financial statements (e.g., the purchase of a business). Their disclosure in the financial statements, however, may be required.

Other-matter paragraph: A paragraph added to a compilation or review report that refers to a matter other than those presented or disclosed in the financial statements that is required by the SSARS or, in the accountant's professional judgment, is important to the users' understanding of the review, the accountant's responsibilities, or the accountant's compilation or review report.

Ratio analysis: This type of *analytical procedure* involves the study of the relationship between two financial statement amounts. Ratios generally assess an aspect of (1) operations, (2) financial position, or (3) operations as related to financial position.

Reasonableness tests: This type of *analytical procedure* consists of tests that estimate a financial statement amount or the change in an amount from the prior year. Generally, they use operating or other nonfinancial data, but sometimes they only use financial information.

Recognized subsequent events: According to FASB ASC 855-10, these are subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet and, if material, require adjustment of the financial statements (e.g., the bankruptcy of a major customer). Occurrence of such events does not require disclosure in the financial statements, but other GAAP requirements may require this event to be disclosed.

Regulatory basis of accounting: The basis of accounting an entity is required to use to meet the requirements of a regulatory agency to which the entity is subject. This is a *special purpose framework*.

Required supplementary information: Any supplementary information that is required to be presented by a recognized accounting standards setting body.

Restricted-use reports: Reports that are intended for the use of only one or more specified third parties.

Special purpose frameworks: Non-GAAP financial reporting frameworks, such as the *contractual basis of accounting* and the *regulatory basis of accounting*.

Split-level reporting: This involves providing different levels of assurance on a single set of financial statements (e.g., auditing the balance sheet and reviewing the income statement).

Summary financial statements: Such statements are presented in less detail than complete financial statements that are intended to present financial position, results of operations, and cash flows. They may be complete financial statements that omit notes or, more typically, financial statements that omit notes and combine statement components.

Supplementary information: Also known as *other*, *additional*, or *accompanying information*, this includes 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. It may be presented in a document containing reviewed or compiled financial statements or separately from such statements.

Trend analysis: This type of *analytical procedure* involves the study of the change in accounts over time, such as comparing current year amounts with prior year amounts or amounts from several successive years.

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This index is a list of general topics discussed in the course. More specific key word searches can be performed using the search feature of this PDF.

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COMPANION TO PPC'S GUIDE TO COMPILATION AND REVIEW ENGAGEMENTS

COURSE 3

BACKGROUND INFORMATION AND ENGAGEMENT ADMINISTRATION FOR COMPILATION AND REVIEW ENGAGEMENTS (CARTG213)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses issues related to compilation and review engagements. Lesson 1 takes a look at the background information all practitioners need to know before tackling these types of engagements, including details about the Accounting and Review Services Committee (ARSC) and the authoritative guidance that applies to such engagements. Lesson 2 takes a look at issues related to engagement administration that practitioners may face when performing compilation and review engagements.
PUBLICATION/ REVISION DATE:	July 2021
RECOMMENDED FOR:	Users of *PPC's Guide to Compilation and Review Engagements*
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 **July 31, 2022**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Background Information for Performing Compilation and Review Engagements

Completion of this lesson will enable you to:

- Identify basic information about the ARSC and the authoritative guidance that applies to compilation and review engagements.

Lesson 2—Engagement Administration

Completion of this lesson will enable you to:

- Identify general principles that apply to SSARS engagements, client acceptance and continuance considerations, whether the SSARS apply to a specific engagement, and how to recommend a level of service.
- Recognize how to deal with engagement letters, changing the engagement type, subsequent events, and the subsequent discovery of facts in compilation and review engagements.
- Determine best practices for workpaper documentation, communication with other accountants, and other practice issues in compilation and review engagements.
- Identify what quality control, peer review, and ethics standards apply to compilation and review engagements.
- Determine how accounting software, independence issues, consultations, and differences of opinion may affect compilation and review engagements.

TO COMPLETE THIS LEARNING PROCESS:

Log onto our Online Grading Center at **cl.tr.com/ogs**. Online grading allows you to get instant CPE credit for your exam.

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

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

  Thomson Reuters
  Tax & Accounting—Checkpoint Learning
  CARTG213 Self-study CPE
  36786 Treasury Center
  Chicago, IL 60694-6700

See the test instructions included with the course materials for additional instructions and payment information.

ADMINISTRATIVE POLICIES

For information regarding refunds and complaint resolutions, dial (800) 431-9025 (Option 2) for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Background Information for Performing Compilation and Review Engagments

INTRODUCTION

This lesson discusses the background information that practitioners should be familiar with before they take on compilation or review engagements. It begins with a discussion of the Accounting and Review Services Committee (ARSC). Then it takes a more in-depth look at the authoritative guidance that applies to these types of engagements with an emphasis on the Statements on Standards for Accounting and Review Services (SSARS).

Learning Objectives:

Completion of this lesson will enable you to:

- Identify basic information about the ARSC and the authoritative guidance that applies to compilation and review engagements.

THE ACCOUNTING AND REVIEW SERVICES COMMITTEE

What Is Its Purpose?

The Accounting and Review Services Committee (ARSC) is a senior technical committee of the American Institute of Certified Public Accountants (AICPA). The mission of ARSC is—

> to serve the public interest by developing, updating, and communicating comprehensive standards and practice guidance that enable accountants of nonissuers to provide high quality, objective SSARSs services to nonissuers in an effective and efficient manner.

What Is Its Scope?

The scope of the Committee's authority is limited to *unaudited financial statements* or *other unaudited financial information* of *nonpublic entities*. The Statements on Auditing Standards (SASs) issued by the ASB provide guidance to CPAs who perform services in connection with *audited financial statements* of *nonissuers*. PCAOB Standards provide guidance to CPAs who perform audit or review services for *issuers*. The FASB provides guidance to determine the content of financial statements in accordance with generally accepted accounting principles. Pronouncements of the ARSC are issued as Statements on Standards for Accounting and Review Services (SSARS). These have been codified in the *AICPA Professional Standards* (AR-Cs).

The term *unaudited* is used in practice when referring to the following financial statements:

a. Prepared financial statements of a nonpublic entity [AR-C 70 (AR-C 70A)].

b. Compiled financial statements of a nonpublic entity [AR-C 80 (AR-C 80A)].

c. Reviewed annual financial statements of a nonpublic entity [AR-C 90 (AR-C 90A)].

d. Reviewed interim financial statements of a nonpublic entity [AR-C 90 or AU-C 930 (AR-C 90A or AU-C 930B)].

What Is Its Authority?

ARSC has been designated by the AICPA Council to promulgate standards under ET Appendix A of the AICPA's *Code of Professional Conduct*. The pronouncements of the ARSC represent the authoritative literature for CPAs when providing accounting and review services to nonpublic entities. However, SSARS do not apply to AICPA members not in public practice.

How Is It Structured?

ARSC has seven members. The Director of the AICPA Audit and Attest Team nominates the ARSC Chair and in consultation with the ARSC Chair, nominates the other members of the ARSC. These nominations are approved by the AICPA Board of Directors.

How Does It Speak?

As previously mentioned, pronouncements by the ARSC are issued as SSARS. As of the date of this course, the ARSC has issued the following pronouncements:

- SSARS No. 1, *Compilation and Review of Financial Statements* (December 1978) (Superseded December 2010 by the issuance of SSARS No. 19).
- SSARS No. 2 (AR 200), *Reporting on Comparative Financial Statements* (October 1979) (Superseded December 2015 by the issuance of SSARS No. 21).
- SSARS No. 3 (AR 300), *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (December 1981) (Superseded December 2015 by the issuance of SSARS No. 21).
- SSARS No. 4 (AR 400), *Communications Between Predecessor and Successor Accountants* (December 1981) (Superseded December 2015 by the issuance of SSARS No. 21).
- SSARS No. 5, *Reporting on Compiled Financial Statements* (July 1982) (Superseded November 1992 by the issuance of SSARS No. 7).
- SSARS No. 6 (AR 600), *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (September 1986) (Superseded December 2015 by the issuance of SSARS No. 21).
- SSARS No. 7, *Omnibus Statement on Standards for Accounting and Review Services—1992* (November 1992) (Not published as a stand-alone section).
- SSARS No. 8, *Amendment to Statement on Standards for Accounting and Review Services No. 1*, *Compilation and Review of Financial Statements* (October 2000) (Not published as a stand-alone section).
- SSARS No. 9, *Omnibus Statement on Standards for Accounting and Review Services—2002* (November 2002) (Not published as a stand-alone section).
- SSARS No. 10, *Performance of Review Engagements* (May 2004) (Not published as a stand-alone section).
- SSARS No. 11, *Standards for Accounting and Review Services* (May 2004) (Superseded December 2010 by the issuance of SSARS No. 19).
- SSARS No. 12, *Omnibus Statement on Standards for Accounting and Review Services—2005* (July 2005) (Not published as a stand-alone section).
- SSARS No. 13 (AR 110), *Compilation of Specified Elements, Accounts, or Items of a Financial Statement* (July 2005) (Superseded December 2015 by the issuance of SSARS No. 21).
- SSARS No. 14 (AR 120), *Compilation of Pro Forma Financial Information* (July 2005) (Superseded September 2016 by the issuance of SSARS No. 22).
- SSARS No. 15, *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services* (July 2007) (Not published as a stand-alone section).
- SSARS No. 16 (AR 20), *Defining Professional Requirements in Statements on Standards for Accounting and Review Services* (December 2007) (Superseded December 2010 by the issuance of SSARS No. 19).

- SSARS No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (February 2008) (Not published as a stand-alone section).
- SSARS No. 18, *Applicability of Statements on Standards for Accounting and Review Services* (February 2009) (Not published as a stand-alone section).
- SSARS No. 19 (AR 60, AR 80, and AR 90), *Compilation and Review Engagements* (December 2009) (Superseded December 2015 by the issuance of SSARS No. 21).
- SSARS No. 20, *Revised Applicability of Statements on Standards for Accounting and Review Services* (February 2011) (Not published as a stand-alone section).
- SSARS No. 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification* (October 2014).
- SSARS No. 22, *Compilation of Pro Forma Financial Information* (September 2016).
- SSARS No. 23, *Omnibus Statement on Standards for Accounting and Review Services—2016* (October 2016).
- SSARS No. 24, *Omnibus Statement on Standards for Accounting and Review Services—2018* (May 2018).
- SSARS No. 25, *Materiality in a Review of Financial Statements and Adverse Conclusions* (February 2020).

The Statements on Standards for Accounting and Review Services (SSARS) Nos. 1–20 were codified into AR Sections. SSARS Nos. 21–25 are codified into AR-C Sections AR-C 60, 60A, 70, 70A, 80, 80A, 90, 90A, 100, and 120. (The pre-SSARS No. 25 guidance was recodified in the A-sections.)

SSARS Interpretations

Interpretations are issued to provide timely guidance on the application of SSARS. Interpretations are issued after all members of ARSC have been provided an opportunity to consider and comment on whether the proposed interpretation is consistent with the SSARS. According to AR-C 60.07 (AR-C 60A.07), SSARS Interpretations are interpretative publications. They are not as authoritative as a SSARS, but CPAs should be aware that they are required to consider applicable interpretative publications when performing their SSARS engagements. Currently, there are no SSARS Interpretations.

AICPA SSARS Engagements Guide

The AICPA Guide: *Preparation, Compilation, and Review Engagements* (AICPA Guide) is developed under the supervision and authority of ARSC and is considered an interpretive publication pursuant to AR-C 60.07 (AR-C 60A.07). The purpose of the AICPA Guide is to assist accountants in preparing, compiling, or reviewing financial statements in accordance with the SSARS. The 2020 version of the AICPA Guide is updated as of June 15, 2020. The 2021 version of the AICPA Guide is not expected to be available until Fall 2021. This course has been updated for the 2020 edition. Since the 2021 edition was not available as of the date of this course, the authors caution accountants to consider any changes made to the AICPA Guide which may be relevant to their engagements.

Technical Questions and Answers (Q&A 9150)

Selected inquiries and replies by the staff of the Technical Information Service of the AICPA are published in the AICPA *Technical Questions and Answers*. Section Q&A 9150 of *Technical Questions and Answers* pertains to preparation, compilation, and review engagements. Views expressed in the *Technical Questions and Answers* are not official opinions of the AICPA or any of its committees, including the ARSC—they must be accepted as the personal views of the individuals who offer them. As of May 2020, the following *nonauthoritative aids* pertaining to SSARS have been issued.

.01 (Withdrawn)
.02 (Withdrawn)
.03 (Withdrawn)
.04 Financial Statements Marked as "Unaudited"
.05 (Withdrawn)
.06 (Withdrawn)
.07 (Withdrawn)
.08 Supplementary Information
.09 (Withdrawn)
.10 (Withdrawn)
.11 (Withdrawn)
.12 (Withdrawn)
.13 (Withdrawn)
.14 (Withdrawn)
.15 (Withdrawn)
.16 (Withdrawn)
.17 (Withdrawn)
.18 Bank Engaged an Accountant to Perform a Compilation Engagement on a Financial Statement of Another Entity
.19 (Withdrawn)
.20 Reissuance of a Review Report When the Accountant's Independence Is Impaired After the Date of the Accountant's Review Report
.21 (Withdrawn)
.22 (Withdrawn)
.23 (Withdrawn)
.24 Issuing a Compilation Report on Financial Statements That Omit Substantially All Disclosures Required by an Applicable Financial Reporting Framework After Issuing a Report for the Same Reporting Period That Include Substantially All Disclosures Required by the Same Financial Reporting Framework
.25 (Withdrawn)
.26 (Withdrawn)
.27 (Withdrawn)
.28 (Withdrawn)
.29 Effects on Compilation and Review Engagements When Management Does Not Assess Whether the Reporting Entity Is the Primary Beneficiary of a Variable Interest Entity and Instructs the Accountant to Not Perform the Assessment
.30 Disclosure of Independence Impairment in the Accountant's Compilation Report on Comparative Financial Statements When the Accountant's Independence Is Impaired in Only One Period
.31 (Withdrawn)
.32 Modification to the Accountant's Compilation or Review Report When a Client Adopts a Private Company Council Accounting Alternative
.33 Compilation or Review Report in Which Management Does Not Include Disclosure Related to Adoption of a PCC Accounting Alternative
.34 (Withdrawn)

Other Accounting, Compilation, and Review Technical Questions and Answers

Following is a listing identifying other accounting, compilation, and review related AICPA *Technical Questions and Answers*, other than the Q&A 9150 series. (See the Q&A 9150 series listing above.)

- Q&A 1300.17, *Omission of Reconciliation of Net Income to Cash Flow From Operations*
- Q&A 1500.07, *Disclosure Concerning Subsequent Events in Special Purpose Financial Statements*
- Q&A 1800.06, *Applicability of Fair Value Disclosure Requirements in FASB ASC 820 to Financial Statements Prepared in Accordance With a Special Purpose Framework*
- Q&A 8800.30, *Making Reference to Review Report*
- Q&A 9110.07, *Statement of Cash Receipts and Disbursements*

The Exhibit at AR-C 60.A65 (AR-C 60A.A53) includes a list of Technical Questions and Answers reviewed by the AICPA staff and, therefore, considered appropriate publications for consideration by the accountant when performing a SSARS engagement [AR-C 60.18 (AR-C 60A.18)].

THE SSARS NO. 21 CODIFICATION

SSARS No. 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification*, superseded all of the existing AR sections other than AR 120, *Compilation of Pro Forma Financial Information*. (The recodification resulting from SSARS No. 21 was amended by SSARS No. 23, SSARS No. 24, and SSARS No. 25, as discussed later in this lesson.) The clarified standards have AR-C references to differentiate them from the previous literature. This is the same method that the AICPA used to differentiate between the old (AU references) and clarified auditing standards (AU-C references). Part of ARSC's goal when drafting SSARS No. 21 was to present the requirements and application and other explanatory guidance in a very concise manner, especially as it relates to preparation and compilation engagements. As a result, much of the guidance formerly included in Interpretations, as well as some other guidance such as the guidance related to comparative financial statements, is not carried forward into SSARS No. 21. Instead, many of those topics are addressed in the AICPA Guide, as discussed earlier in this lesson.

SSARS No. 21 is comprised of four sections—

- AR-C 60A, *General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services*.
- AR-C 70A, *Preparation of Financial Statements*.
- AR-C 80A, *Compilation Engagements*.
- AR-C 90A, *Review of Financial Statements*.

Each of the AR-C Sections are discussed in the following paragraphs.

AR-C 60A—General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services

AR-C 60A provides general principles for any engagements performed in accordance with the SSARS and is intended to help accountants understand their professional responsibilities when performing SSARS engagements. AR-C 60A addresses—

- *Financial Statements.* The financial statements belong to the entity. The SSARS do not impose responsibilities on management of the entity, and do not override laws and regulations that govern the entity.
- *Ethical Responsibilities.* The accountant should comply with ethical requirements. See the discussion of ethics standards in Lesson 2.

- *Professional Judgment.* The accountant should exercise professional judgment when performing a SSARS engagement.
- *Conduct of the Engagement in Accordance with the SSARS.* The accountant should comply with all relevant sections of the SSARS. In addition, the accountant should understand the requirements of the SSARS and the application and other explanatory materials in order to properly apply the requirements of the SSARS. This course incorporates the requirements of the SSARS throughout.
- *Engagement-level Quality Control.* See the discussion in Lesson 2.
- *Acceptance and Continuance of Client Relationships and Engagements.* See the discussion in Lesson 2.

AR-C 60A provides the overall framework for conducting an engagement in accordance with SSARS and defines certain terms used in the SSARS to describe the professional requirements imposed by accountants performing compilation and review engagements.

Unconditional requirements are defined as requirements with which accountants are required to comply in all cases in which the circumstances exist to which the requirement applies. Such requirements are introduced by the word *must*.

Presumptively mandatory requirements are requirements with which accountants are required to comply in all cases in which the circumstances exist to which the requirement applies. However, accountants may depart from such a requirement if they justify the departure and how alternative procedure(s) performed in the circumstances were sufficient to achieve the objectives of the requirement. Such requirements are introduced by the word *should*.

AR-C 70A—Preparation of Financial Statements

AR-C 70A applies when an accountant is engaged to prepare financial statements, but is not engaged to perform an audit, review, or compilation of those statements. (There are other more narrow exemptions from the requirements of AR-C 70A listed at AR-C 70A.01, as discussed later in this lesson.) It establishes the performance requirements for the preparation of financial statements. AR-C 70A engagement letters are discussed in Lesson 2.

AR-C 80A—Compilation Engagements

AR-C 80A establishes the standards and provides guidance on compilations of financial statements. The accountant is required to comply with the provisions of AR-C 80A whenever he or she is engaged to report on compiled financial statements. AR-C 80A engagement letters are discussed in Lesson 2.

AR-C 90A—Review of Financial Statements

AR-C 90A establishes the standards and provides guidance on reviews of financial statements. The accountant is required to comply with the provisions of AR-C 90A whenever he or she is engaged to review financial statements, except for the reviews of interim financial information when AU-C 930 (AU-C 930B) applies. AR-C 90A engagement letters are discussed in Lesson 2.

SSARS NO. 22, *COMPILATION OF PRO FORMA FINANCIAL INFORMATION*

In September 2016, the ARSC issued SSARS No. 22. SSARS No. 22 (AR-C 120) superseded AR 120 and put the requirements and guidance in clarity format. Pro forma financial information is beyond the scope of this course. *PPC's Guide to Nontraditional Engagements* discusses pro forma financial information.

SSARS NO. 23, *OMNIBUS STATEMENT ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES—2016*

In October 2016, the ARSC issued SSARS No. 23. SSARS No. 23 made the following amendments to SSARS No. 21:

- AR-C 60A amendments:
  - Revised the SSARS to apply to engagements performed on subject matter other than financial statements.
  - Added the definitions of *financial statements* and *prospective financial information*.
  - Revised the definitions of *engagement team* and *professional judgment* to be consistent with those included in the clarified auditing standards.
  - Clarified the definition of *other preparation, compilation, and review publications*.
  - Added a mandatory requirement for the accountant to document the justification for a departure from a presumptively mandatory requirement, the alternative procedures performed, and how those procedures achieved the intent of the requirement.
  - Revised the requirement for the accountant to obtain the agreement of management that it acknowledges and understands its responsibility for the design, implementation, and maintenance of internal control so that the requirement does not apply if the accountant decides to accept responsibility for such internal control.
- AR-C 70A amendments:
  - Expanded the subject matter to which the section should be applied to include prospective financial information.
  - Noted that the AICPA Guide, *Prospective Financial Information*, provides comprehensive guidances regarding prospective financial information.
  - Clarified the nature of the engagement letter and makes it clear that an oral understanding is not sufficient.
  - Clarified that when the accountant is unable to add the phrase "no assurance is provided" on each page of the financial statements, the accountant may not only issue a disclaimer or perform a compilation, but also withdraw from the engagement.
  - Added a requirement that the accountant should not prepare prospective financial information that excludes disclosure of the summary of significant assumptions or a financial projection that excludes either the hypothetical assumptions or the limitations on the usefulness of the presentation.
- AR-C 80A amendments:
  - Expanded the subject matter to which the section should be applied to include prospective financial information and pro forma financial information.
  - Noted that the AICPA Guide, *Prospective Financial Information*, provides comprehensive guidance regarding prospective financial information.
  - Clarified the nature of the engagement letter and makes it clear that an oral understanding is not sufficient.
  - Harmonized the guidance with respect to the requirement that the accountant's compilation report include the signature of the accountant or the accountant's firm with the comparable requirement in AR-C 90A.

- Added requirements when the accountant is issuing a compilation report on prospective financial information.
- Clarified that the accountant is required to disclose known departures from the applicable financial reporting framework in the accountant's compilation report and that when the accountant becomes aware of a material departure and the financial statements are not revised, the accountant is required to consider whether modification of the report is adequate to disclose the departure.

- AR-C 90A amendments:
  - Clarified that AR-C 90A applies to reviews of all historical financial information other than pro forma financial information.
  - Clarified the definition of *supplementary information*.
  - Clarified the nature of the engagement letter and makes it clear that an oral understanding is not sufficient.
  - Revised the language used to describe the requirement that the engagement letter be signed by both the accountant and management to be consistent with the language used in AR-C 70A and AR-C 80A.
  - Harmonized the guidance with respect to the requirement that the accountant's review report include the signature of the accountant or the accountant's firm with the comparable requirement in AR-C 80A.
  - Revised the accountant's reporting responsibilities when supplementary information accompanies reviewed financial statements and the accountant's review report on those financial statements.

Prospective financial information is beyond the scope of this course. Detailed guidance and applicable practice aids on prospective financial information are available in *PPC's Guide to Forecasts and Projections*.

SSARS NO. 24, *OMNIBUS STATEMENT ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES—2018*

In May 2018, the ARSC issued SSARS No. 24. SSARS No. 24 made the following revisions to the SSARS:

- Amended AR-C 60A as follows:
  - Added a definition of *fair presentation framework*.
  - Revised the definition of *financial reporting framework*.
  - Added a paragraph to the application guidance that makes it clear that if an accountant accepts responsibility for the design, implementation, and maintenance of internal control, the accountant's independence is impaired.

- Amended AR-C 90A as follows:
  - Added a definition of *reasonable period of time*.
  - Added a required written representation about disclosing all information pertaining to the use of the going concern assumption in the financial statements.
  - Revised the review report requirements to make them consistent with the illustrative review report examples.
  - Required the accountant to perform review procedures related to all of the following (if the entity's management is required to evaluate the entity's ability to continue as a going concern for a reasonable period of time by the applicable financial reporting framework):

- The appropriateness of the going concern basis of accounting.
- Management's evaluation of conditions or events that raise substantial doubt about the entity's ability to continue as a going concern and, if any, management's plans to mitigate them.
- The adequacy of going concern disclosures.

•• Required the accountant to perform the following procedures (if the entity's management is *not* required to evaluate the entity's ability to continue as a going concern for a reasonable period of time by the applicable financial report framework and substantial doubt is raised during the review or existed at the date of the prior period financial statements):

- Inquire of management about the appropriateness of the going concern basis of accounting.
- Inquire of management about its plans to mitigate any conditions or events that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- Consider the adequacy of the going concern disclosures.

•• Required the accountant to include an emphasis-of-matter paragraph in the review report if the accountant believes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains after considering conditions, events, and management's plans.

•• Precluded the accountant from referencing, in the review report, the report of other accountants when that report is restricted in use.

•• Required the accountant of the reporting entity to ensure that the other accountants understand the ethical requirements pertaining to the engagement, including the independence requirements. Also requires the accountant to determine that the other accountants are familiar with the applicable financial reporting framework and SSARS or SAS, as applicable, and will conduct the review or audit in accordance with the applicable standards.

•• Precluded the accountant from referencing the review or audit of other accountants in the review report of the reporting entity if the component's financial statements and reporting entity's financial statements are prepared using different financial reporting frameworks unless—

- the accountant of the reporting entity has obtained sufficient appropriate review evidence of the adjustments needed to convert the component's financial statements to the financial reporting framework used by the reporting entity, or
- the measurement, recognition, presentation, and disclosure criteria applicable to all material items in the component's financial statements are similar to those of the reporting entity's financial statements.

- Added AR-C 100, *Special Considerations—International Reporting Issues*, to provide requirements and guidance when—

  •• an accountant performs a compilation or review in accordance with both the SSARS and another set of compilation or review standards, or

  •• an accountant is engaged to perform a compilation or review of financial statements that have been prepared using a financial reporting framework generally accepted in another country.

- Withdrew Interpretation No. 1 of AR-C 90A, *Considerations Related to Reviews Performed in Accordance With International Standard on Review Engagements (ISRE) 2400 (Revised)*, *Engagements to Review Historical Financial Statements*.

RECENT DEVELOPMENTS RELATED TO THE SSARS

Issuance of SSARS No. 25, *Materiality in a Review of Financial Statements and Adverse Conclusions*

In February 2020, the AICPA Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 25, *Materiality in a Review of Financial Statements and Adverse Conclusions*. These amendments to the SSARS are a result of ARSC's project to converge AR-C 90, *Review of Financial Statements*, with International Standard on Review Engagements (ISRE) 2400, *Engagements to Review Historical Financial Statements (Revised)*, and remove inconsistencies between the SSARS and the auditing standards with respect to concepts that should apply to all service levels.

In general, SSARS No. 25 provides for the following:

- Makes explicit the requirement that the accountant should determine materiality for the financial statements as a whole and apply this benchmark when designing procedures and evaluating results. Such a requirement is already inherent in the extant standards because the accountant's review report concludes on whether the accountant is aware of any material modifications that would need to be made to the financial statements to comply with the applicable financial reporting framework.
- Provides for an adverse conclusion in a review report when there is evidence of pervasive and material misstatement of the financial statements. Under the extant standards, the accountant's only recourse is to withdraw from the engagement.
- Revises the accountant's review report to state that the accountant is required to be independent with respect to the entity and also to comply with ethical responsibilities under the relevant professional standards.
- Provides language clarifying existing requirements and expands application guidance.

SSARS No. 25 is effective for engagements performed in accordance with SSARS for periods ending on or after December 15, 2021, with early implementation permitted, and is codified at AR-C 60, AR-C 70, AR-C 80, and AR-C 90. Pre-SSARS No. 25 standards are recodified at AR-C 60A, AR-C 70A, AR-C 80A, and AR-C 90A.This course fully implements SSARS No. 25, by providing dual guidance throughout.

Specific amendments to AR-C 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*; AR-C 70, *Preparation of Financial Statements*; AR-C 80, *Compilation Engagements*; and AR-C 90, *Review of Financial Statements*; are as follows:

- Amends AR-C 60 as follows:
  - Aligns the definition of *financial statements* to be consistent with the definition of that term in the auditing standards.
  - Adds the definitions of *applicable financial reporting framework*, *designated accounting standard setter*, and *special purpose framework*, which were deleted and moved from other SSARS sections, to AR-C 60.07.
  - Adds definitions of *general purpose financial statements*, *special purpose financial statements*, and *general purpose framework* consistent with the definitions of those terms in the auditing standards.
- Amends AR-C 70 as follows:
  - Deletes and moves the definitions of *applicable financial reporting framework* and *special purpose framework* to AR-C 60.07.
  - Permits the accountant to disclose a material misstatement(s) in the financial statements or withdraw from the engagement when management does not provide additional or corrected information when the accountant becomes aware that the records, documents, explanations, or other information,

including significant judgments, used in the preparation of financial statements are incomplete, inaccurate, or otherwise unsatisfactory.

- Requires the accountant to inform management of the reasons for withdrawing when the accountant intends to withdraw from the engagement because (1) the accountant is unable to include a statement on each page of the financial statements indicating, at a minimum, that "no assurance is provided" on the financial statements; or (2) management does not provide additional or corrected information when the accountant becomes aware that the records, documents, explanations, or other information, including significant judgments, used in the preparation of financial statements are incomplete, inaccurate, or otherwise unsatisfactory.
- Adds the option for the accountant to disclose the omission of substantially all disclosures in a disclaimer. Prior to SSARS No. 25, such disclosure was required to be made in the financial statements.
- Deletes the requirement for the accountant to determine whether management intends to mislead users by omitting substantially all disclosures. Instead, the accountant is required to determine whether, in the accountant's professional judgement, the omission would be misleading to users.

- Amends AR-C 80 as follows:
  - Deletes and moves the definitions of *applicable financial reporting framework* and *special purpose framework* to AR-C 60.07.
  - Eliminates the requirement that the accountant's report on special purpose financial statements prepared in accordance with the regulatory or contractual basis of accounting disclose the purpose for which the financial statements are prepared. (AR-C 80.21b already requires the accountant's compilation report to refer to the note in the financial statements that describes the framework.)
  - Expands disclosures for the accountant's report on special purpose financial statements prepared in accordance with the provisions of a contract to add a statement that the financial statements may not be suitable for another purpose.
  - Deletes the requirement for the accountant to determine whether management intends to mislead users by omitting substantially all disclosures. Instead, the accountant is required to determine whether, in the accountant's professional judgement, the omission would be misleading to users.
- Amends AR-C 90 as follows:
  - Deletes and moves the definitions of *applicable financial reporting framework*, *designated accounting standard setter*, and *special purpose framework* to AR-C 60.07.
  - Adds the definitions of *inquiry*, *limited assurance*, *modified conclusion*, *pervasive*, and *professional skepticism*.
  - Revises the definition of *review evidence*.
  - Adds an explicit requirement for the accountant to plan and perform the review with professional skepticism.
  - Adds required procedures if, after the engagement is accepted, the accountant is not satisfied that preconditions at AR-C 60.26 or AR-C 90.13 have been met.
  - Makes explicit that the requirement to agree on the terms of the engagement is satisfied prior to commencement of the engagement.
  - Adds a requirement that the agreement of the terms of the engagement should include a statement that a review is substantially less in scope than an audit and that the accountant will not express an opinion on the financial statements.

- Adds an explicit requirement for the accountant to determine materiality for the financial statements as a whole and apply materiality in designing procedures and evaluating the results of the procedures performed. Further, the accountant is required to revise materiality if the accountant becomes aware of information that would have resulted in a different initial materiality amount.
- Significantly revises the list of inquiries the accountant is required to make of members of management who have responsibility for financial and accounting matters, and others as appropriate, concerning the financial statements.
- Adds a requirement for the accountant to remain alert for evidence of related-party relationships or transactions not previously identified.
- Adds inquiries the accountant should make of management if, in the course of performing review procedures, the accountant becomes aware of significant transactions outside the normal course of business.
- Adds a requirement when using the work of others to ensure the work performed is adequate for the accountant's purposes.
- Eliminates the requirement that the accountant's report on special purpose financial statements prepared in accordance with the regulatory or contractual basis of accounting disclose the purpose for which the financial statements are prepared.
- Expands disclosures for the accountant's report on special purpose financial statements prepared in accordance with the provisions of a contract to add a statement that the financial statements may not be suitable for another purpose.
- Limits the requirement for a use restriction for the accountant's report to special purpose financial statements prepared in accordance with the contractual basis of accounting.
- Allows the accountant to express an adverse conclusion when the financial statements are materially and pervasively misstated and provides illustrative language.
- Requires the accountant to document communications with management, those charged with governance, and others about significant matters arising during the engagement, including the nature of such matters.
- Requires the accountant to document information that is inconsistent with the accountant's findings regarding significant matters that affect the financial statements and how those inconsistencies were addressed.
- Requires the accountant to document (a) who performed procedures and the date procedure were completed; and (b) who performed the technical review necessary to assure engagement quality control, the extent of such review, and the date the review was performed.

SSARS No. 25 is available on the AICPA website at **www.aicpa.org/content/dam/aicpa/interestareas/frc/reviewcompilationpreparation/downloadabledocuments/ssars25/ssars-25.pdf** and on Checkpoint at **https://checkpoint.riag.com/**.

Project to Revise the SSARS for Quality Management Changes

In February 2021, the AICPA issued Proposed Statements on Quality Management Standards (SQMS) No. 1, *A Firm's System of Quality Management*, which will supersede QC 10. The proposed SQMS takes a new approach in addressing the firm's responsibility to design, implement, and operate a system of quality management for its accounting and auditing practice by emphasizing the responsibility of firm leadership for proactively managing quality. If issued as proposed, firms would be required to design and implement systems of quality management in compliance with proposed SQMS No. 1 by December 15, 2023, and to perform an evaluation of the system of quality management required by proposed SQMS No. 1 within one year following December 15, 2023. Future editions of

this course will be updated for any new developments. More information about this project is available at **www.aicpa.org**.

At its May 2021 meeting, the ARSC deliberated proposed amendments to AR-C 60 and AR-C 90 to update those sections based on proposed SQMS No. 1. The ARSC expects to issue an exposure draft of the proposed SSARS, *Quality Management for an Engagement Performed in Accordance with Statement on Standards for Accounting and Review Services*, in Fall 2021. A final SSARS with an effective date for periods ending on or after December 15, 2023, is expected to be issued in the first or second quarter of 2022. Future editions of this course will update the status of this project. Ethical requirements are discussed in Lesson 2.

FINANCIAL STATEMENT PREPARATION ENGAGEMENTS UNDER THE SSARS

AR-C 70, *Preparation of Financial Statements* (AR-C 70A), allows accountants to prepare financial statements without issuing a report and does not limit the distribution of those statements. It applies when an accountant in public practice is engaged to prepare financial statements or prospective financial information, but is not engaged to perform a compilation, review, or audit of those financial statements or prospective financial information. (Accountants who are not in public practice are not subject to the requirements of AR-C 70 (AR-C 70A). ET 0.400.42 defines *public practice* as providing services for a client.) SSARS No. 23 amended SSARS No. 21 to expand the scope of AR-C 70 (AR-C 70A) to include engagements to prepare prospective financial information. Such engagements are beyond the scope of this course and are instead discussed in *PPC's Guide to Forecasts and Projections*. [Other limited situations in which AR-C 70 (AR-C 70A) does not apply are listed below.] The standard is *engagement driven*, meaning that the accountant is required to comply with the requirements of AR-C 70 (AR-C 70A) only when he or she has been *engaged to prepare financial statements*. However, the accountant must use professional judgment to determine whether he or she has been engaged to prepare financial statements or merely to assist in the preparation of those statements. In making this determination, the accountant has to consider what services the client has requested the accountant perform.

AR-C 70 (AR-C 70A) *does not* apply when the accountant prepares financial statements to be—

- submitted solely to taxing authorities;
- included in written personal financial plans that he or she has prepared;
- used in conjunction with litigation services involving legal or regulatory proceedings, either pending or potential; or
- used in connection with business valuation services.

Simply stated, AR-C 70 (AR-C 70A) applies when an accountant is engaged to prepare financial statements that are not for any of those purposes.

Objective

The objective of an AR-C 70 (AR-C 70A) financial statement preparation engagement is to prepare financial statements in accordance with the applicable financial reporting framework (i.e., GAAP, special purpose framework, or other acceptable basis). Accountants engaged to prepare financial statements in accordance with AR-C 70 (AR-C 70A) should comply with all relevant requirements of the standard. In addition, they should comply with the general principles set forth in AR-C 60, *General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services* (AR-C 60A), which apply to all engagements performed in accordance with SSARS. This includes complying with certain conditions described in AR-C 60.26 (AR-C 60A.26) prior to accepting a financial statement preparation engagement.

SSARS No. 23 amended SSARS No. 21 to expand the scope of AR-C 70 (AR-C 70A) to include engagements to prepare prospective financial information. Such engagements are beyond the scope of this course, but more information is available in *PPC's Guide to Forecasts and Projections*.

Performance Requirements

If the accountant determines that he or she has been engaged to prepare financial statements, the accountant is required to follow the performance requirements in AR-C 70 (AR-C 70A). An accountant engaged to prepare the financial statements should:

a. Address accepting or continuing the engagement [AR-C 70.09 (AR-C 70A.09)]. Acceptance and continuance are discussed in Lesson 2.

b. Establish an understanding with the client regarding the services to be performed and document the understanding through a written communication signed by both the accountant or the accountant's firm and management [AR-C 70.10–.11 (AR-C 70A.10–.11)]. Engagement letters are discussed in Lesson 2.

c. Understand the client's applicable financial reporting framework (cash, tax, GAAP, etc.) [AR-C 70.12 (AR-C 70A.12)]. See the discussion on understanding the applicable financial reporting framework below.

d. Prepare the financial statements in accordance with the applicable financial reporting framework [AR-C 70.13 (AR-C 70A.13)], with specific requirements related to financial statements prepared using a special purpose framework [AR-C 70.15 (AR-C 70A.15)] and financial statements that omit substantially all disclosures [AR-C 70.20–.21 (AR-C 70A.20–.21)]. In addition, a known departure or departures from the applicable financial reporting framework must be disclosed either on the face of the financial statements or in a note to the financial statements [AR-C 70.18 (AR-C 70A.18)]. See the discussion on preparing the financial statements later in this section.

e. Ensure that a statement (commonly referred to as a legend) that no assurance is being provided is included on each page of the financial statements [AR-C 70.14 (AR-C 70A.14)]. If the financial statements do not include a legend indicating that no assurance is provided, the CPA should either perform a compilation engagement or issue a disclaimer that makes it clear that the CPA is providing no assurance. See the discussion on financial statement legends later in this lesson.

f. If the financial statements are prepared in accordance with a special purpose framework (such as cash basis or tax basis), include a description of the financial reporting framework on the face of the financial statements or in a note to the financial statements. The description is usually placed next to or under the title of the financial statements (for example, "Statement of Revenues and Expenses—Cash Basis") [AR-C 70.15 (AR-C 70A.15)].

g. Ensure that management understands and accepts responsibility for any significant judgments regarding amounts or disclosures reflected in the financial statements with which the accountant has assisted management [AR-C 70.16 (AR-C 70A.16)]. See the discussion on significant judgments later in this lesson.

h. Request additional or corrected information when the accountant becomes aware that information supplied by the client is incorrect, incomplete, or otherwise unsatisfactory [AR-C 70.17(AR-C 70A.17)]. See the discussion later in this lesson.

i. Disclose the omission of substantially all disclosures required by the applicable financial reporting framework (if applicable) on the face of the financial statement or in a note to the financial statements. This disclosure may be labeled "Selected Information—Substantially All Disclosures Required by [the applicable financial reporting framework] Are Not Included" [AR-C 70.20 (AR-C 70A.20)]. See the discussion later in this lesson.

j. Prepare documentation in sufficient detail to provide a clear understanding of the work performed. At a minimum, this documentation should include the engagement letter and a copy of the financial statements that the accountant has prepared [AR-C 70.22 (AR-C 70A.22)]. See the discussion on documentation in a preparation engagement later in this lesson.

Compliance with professional standards and peer review requirements in an AR-C 70 (AR-C 70A) engagement should be documented. One method for doing so is by using the form provided in *PPC's Guide to Compilation and Review Engagements*.

Knowledge and Understanding of the Applicable Financial Reporting Framework. AR-C 60.07 (AR-C 60A.07) describes a *financial reporting framework* as a set of measurement, recognition, presentation, and disclosure criteria used to determine all of the material items appearing in the financial statements [e.g., accounting principles generally accepted in the United States of America (U.S. GAAP), International Financial Reporting Standards promulgated by the International Accounting Standards Board, or a special purpose framework].

AR-C 70.12 (AR-C 70A.12) requires the accountant to obtain an understanding of the financial reporting framework and the significant accounting policies that management has elected to use to prepare the financial statements.

The requirement to obtain an understanding does not prevent the accountant from accepting a preparation engagement for an entity that operates in an industry in which the accountant lacks previous experience. That is because the accountant may obtain the required understanding prior to the issuance of the financial statements in a variety of ways, including by (a) reading AICPA guides, industry publications, financial statements of other entities in the same industry, relevant textbooks and periodicals; (b) attending appropriate continuing professional education classes; or (c) consulting with knowledgeable individuals.

Preparation of the Financial Statements. An accountant engaged to prepare a client's financial statements in accordance with AR-C 70 (AR-C 70A) should use information provided by management, which includes financial records, documents, explanations, and other information [AR-C 70.13 (AR-C 70A.13)]. The accountant may rely on such information without verifying the accuracy or completeness of the information provided. AR-C 70.04 (AR-C 70A.04) clarifies that the accountant is not expected to gather any evidence to express an opinion, form a conclusion, or otherwise report on the financial statements.

The form of the information provided by management in a financial statement preparation engagement may vary from engagement to engagement. However, ordinarily it will include records, documents, explanations, and other information relevant to the preparation of the financial statements in accordance with the applicable financial reporting framework that management has selected to use to prepare the statements. Other information that management might provide includes information about its assumptions, intentions, or plans underlying the development of accounting estimates used in the preparation of the statements.

In some financial statement preparation engagements, management may request the accountant to assist it with making significant judgments about amounts or disclosures to be reflected in the financial statements. For example, the accountant may advise management on alternative accounting policies that may be used to prepare the statements or assist management with significant judgments affecting material accounting estimates. In such engagements, AR-C 70.16 (AR-C 70A.16) requires the accountant to discuss those judgments with management to ensure that management understands how they affect the financial statements and accepts responsibility for them. Compliance with AR-C 70.16 (AR-C 70A.16) should be documented, perhaps by using the form provided in *PPC's Guide to Compilation and Review Engagements*.

However, if the accountant becomes aware that any of the information supplied by management to prepare the financial statements is incorrect, incomplete, or otherwise unsatisfactory, AR-C 70.17 (AR-C 70A.17) requires the accountant to bring that to the attention of management and request additional or corrected information. If management refuses to provide additional or revised information, the authors believe the accountant should withdraw from the engagement. After implementing SSARS No. 25, the accountant should disclose any resulting material misstatement(s) in the financial statements, or withdraw from the engagement and inform management of the reasons for withdrawal. The authors recommend consulting with legal counsel prior to withdrawal from any engagement.

In certain circumstances, management might request the accountant to prepare financial statements that contain one or more known departures from the applicable financial reporting framework (including inadequate disclosure). As an example, assume that an entity prepares both interim and annual financial statements. While management plans to use GAAP to prepare the year-end financial statements, it might request that the interim financial statements be prepared without the required accruals for income taxes, bonuses, depreciation, etc., and without adjustments to record inventories to actual. If the accountant is engaged to prepare financial statements that contain a known departure or departures from the applicable financial reporting framework, AR-C 70.18 (AR-C 70A.18) requires the

accountant to disclose the material misstatement or misstatements either on the face of the financial statements or in a note to the financial statements.

If the financial statements are prepared in accordance with a special purpose framework, AR-C 70.15 (AR-C 70A.15) requires the accountant to include a description of the financial reporting framework on the face of the financial statements or in a note to the financial statements. Usually, the description is placed next to or under the title of the financial statements (e.g., "statement of assets and liabilities—modified cash basis"). However, the description may be included elsewhere in the financial statements.

In addition, management might request the accountant to prepare financial statements that omit substantially all disclosures required by the applicable financial reporting framework. For example, as discussed above, management might request the accountant to prepare interim financial statements that omit substantially all disclosures. While AR-C 70 (AR-C 70A) permits the preparation of such statements, it prohibits accountants from preparing them if the accountant becomes aware that the omission was undertaken with the intention of misleading intended users of such statements. When the accountant is engaged to prepare financial statements that omit substantially all disclosures required by the applicable financial reporting framework, AR-C 70.20 (AR-C 70A.20) requires the accountant to disclose such omission in the financial statements. The authors believe such a disclosure may be made on the face of the financial statements or in a selected note to the financial statements. After implementing SSARS No. 25, the disclosure of the omission of substantially all disclosures may be made in an accompanying disclaimer.

The accountant may also be engaged to prepare financial statements that include disclosures about only selected matters in the notes to the financial statements. AR-C 70.A19AR-C 70A.A19 indicates that such disclosures may be labeled "Selected Information—Substantially All Disclosures Required by [the applicable financial reporting framework] Are Not Included." As is the case with financial statements that omit substantially all disclosures, accountants are prohibited from preparing financial statements that include only selected information if the intent of such presentation is to mislead the intended users of the financial statements. In addition, when preparing financial statements with selected disclosures, the accountant should consider whether the financial statements include more than a few disclosures. If the notes to the financial statements include more than a few disclosures, then the accountant would need to treat each disclosure omitted as a departure from the applicable financial reporting framework.

Preparing financial statements that omit substantially all disclosures does not reduce the accountant's responsibility to prepare the financial statements themselves appropriately. Although the SSARS do not address the topic specifically beyond the requirements at AR-C 70.17 (AR-C 70A.17), the peer review checklist for SSARS preparation engagements includes questions for use on engagements involving financial statements that omit substantially all disclosures addressing appropriate presentation of the financial statements.

Legend Included in the Financial Statements. AR-C 70.14 (AR-C 70A.14) requires the accountant to ensure that each page of the financial statements (and related notes) includes, at a minimum, a statement that "no assurance is provided" on the statements. Such a statement is intended to avoid users' misunderstandings with respect to the accountant's involvement with the financial statements. Neither the name of the accountant nor the accountant's firm name is required to be included in the statements. In fact, there is no requirement in AR-C 70 (AR-C 70A) that they be included anywhere on the financial statements.

Because the statement is made at management's discretion, the accountant cannot dictate the exact language used. In any event, the accountant's main concern is that the statements not be misleading to users. Examples of statements that usually would be acceptable include the following:

- No assurance is provided on these financial statements.
- These financial statements have not been subjected to an audit or review or compilation engagement, and no assurance is provided on them.

Also acceptable would be other statements that convey that no assurance is provided on the financial statements.

If management refuses to include such a statement on each page of the financial statements, or the accountant is unable to include such a statement, AR-C 70.14 (AR-C 70A.14) states that the accountant should—

- issue a disclaimer that clarifies that no assurance is provided on the financial statements,
- perform a compilation engagement in accordance with AR-C 80, *Compilation Engagements* (AR-C 80A), or
- withdraw from the engagement, and, after implementing SSARS No. 25, inform management of the reasons for withdrawal.

Documentation. AR-C 70.22 (AR-C 70A.22) requires the accountant to prepare documentation in sufficient detail to provide a clear understanding of the work performed in connection with each preparation engagement. At a minimum, that documentation should include—

a. the signed engagement letter or other suitable form of written documentation with management, as described in Lesson 2, and

b. a copy of the financial statements prepared by the accountant.

The accountant is also required to document certain matters in the rare circumstance in which an accountant departs from a relevant presumptively mandatory requirement as discussed earlier in this lesson. In that case, the accountant must document (a) the justification for the departure and (b) how the alternative procedures performed by the accountant were sufficient to satisfy the intent of the requirement. This is consistent with the requirement at AR-C 60.17 (AR-C 60A.17).

While the authors recommend that the workpapers for a preparation engagement generally contain only the specific elements required by AR-C 70 (AR-C 70A) or by other relevant authoritative standards, other matters that might be documented in the workpapers when encountered in a preparation engagement include—

- Consultations with someone not involved in the engagement on complex technical or ethical issues.
- Discussions with management about significant judgments made by the accountant regarding amounts or disclosures to be reflected in the financial statements.
- Differences of opinion among firm personnel on the engagement team, those consulted, or between the engagement partner and the engagement quality control reviewer.
- Significant matters that result in the firm withdrawing from an engagement and the client relationship.

ET 1.295 of the AICPA *Code of Professional Conduct* requires accountants who perform nonattest services for their compilation or review clients to document in writing their understanding concerning those nonattest services. Nonattest services are discussed in Lesson 2.

RECENT ACCOUNTING DEVELOPMENTS THAT MAY APPLY

Generally accepted accounting principles (or a special purpose framework) are the same for any financial statements regardless of whether they are prepared, compiled, reviewed, or audited. To perform a SSARS engagement successfully, the CPA should have an adequate understanding of the accounting principles and practices that may be pertinent to the particular client and their circumstances. *PPC's Guide to Compilation and Review Engagements* provides a disclosure checklist that lists the primary disclosure requirements for financial statements of *nonpublic entities* as required by GAAP. However, that checklist is not a GAAP application checklist; accordingly, GAAP application and measurement questions are not included. Further information regarding GAAP application and measurement can be found in *PPC's Guide to Preparing Financial Statements* and *PPC's Guide to GAAP*.

THE INTERNATIONAL COMPILATION AND REVIEW STANDARDS

The International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) issued International Standard on Related Services (ISRS) 4410, *Compilation Engagements*, and International Standard on Review Engagements (ISRE) 2400, *Engagements to Review Historical Financial Statements*. The purpose of this ISRS and ISRE is to—

- Establish international standards and provide guidance on the accountant's professional responsibilities when engaged to compile or review financial statements.
- Provide guidance on the form and content of the report the accountant issues for that compilation or review.

ISRS 4410 and ISRE 2400 can be found in IFAC's *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*, which can be ordered at **www.ifac.org**.

AR-C 100, *Special Considerations—International Reporting Issues*

AR-C 100, *Special Considerations—International Reporting Issues*, provides requirements and guidance when an accountant—

- performs a compilation or review in accordance with both the SSARS and another set of compilation or review standards, or
- is engaged to perform a compilation or review of financial statements that have been prepared using a financial reporting framework generally accepted in another country.

AR-C 100 does not apply to financial statements prepared in accordance with financial reporting frameworks established by the bodies designated by the AICPA. AR-C 80 (AR-C 80A) and AR-C 90 (AR-C 90A) apply to compilations and reviews, respectively, of financial statements prepared in accordance with financial reporting frameworks established by the bodies designated by the AICPA. AR-C 100 addresses the special considerations that pertain to the engagements listed in the previous paragraph.

Engagement Acceptance. As a condition for accepting a SSARS engagement, AR-C 60.26a (AR-C 60A.26b) requires the accountant to determine whether the financial reporting framework management has selected to use to prepare the financial statements is acceptable. For a compilation or review of financial statements prepared in accordance with a financial reporting framework generally accepted in another country, the accountant should obtain an understanding of—

- why the financial statements are being prepared,
- whether the financial reporting framework being used to prepare the financial statements is a fair presentation framework,
- the intended users of the financial statements, and
- what management has done to conclude that the financial reporting framework chosen is acceptable in the circumstances.

When the compilation or review engagement is going to be performed in accordance with both the SSARS and another set of compilation or review standards, the financial statement are intended for use only outside of the United States, and the accountant intends for the report to use the form and content of the other set of compilation or review standards; the accountant should obtain an understanding of the applicable legal responsibilities involved.

Planning and Performing the Engagement. AR-C 80.12 (AR-C 80A.12) requires the accountant to obtain an understanding of the financial reporting framework and significant accounting policies being used to prepare the financial statements. AR-C 90.22–.23 (AR-C 90A.15–.16) require the accountant to obtain an understanding of the accounting principles and practices used in order to identify areas in the financial statements where there may be a greater chance of material misstatements and design procedures to address those areas. An understanding of the financial reporting framework generally accepted in another country may be obtained by reading applicable statutes,

professional literature, or codifications or by consulting with individuals who have expertise in applying the financial reporting framework of the other country.

The accountant should comply with AR-C 80 (AR-C 80A) or AR-C 90 (AR-C 90A) for compilations or reviews of financial statements prepared in accordance with a financial reporting framework generally accepted in another country. However, if the financial statements are intended for use only outside of the United States, the accountant may use the report content and form of the other country. If the accountant is engaged to perform a compilation or review of financial statements in accordance with the SSARS and another set of compilation or review standards, the accountant should apply the standards of the other country, as well as the SSARS, except for the requirements related to the form and content of the report.

Reporting. If the financial statements are intended for use in the United States, the accountant should follow the SSARS reporting requirements, including the requirements related to financial statement prepared in accordance with a special purpose framework.

If the financial statements are intended for use only outside the United States, the accountant has two options:

1. Report in accordance with the SSARS and include the following:
    a. The reporting elements required by AR-C 80 (AR-C 80A) or AR-C 90 (AR-C 90A), as applicable, excluding the requirements for an additional paragraph related to financial statement prepared in accordance with a special purpose framework.
    b. Add a statement that refers to a note to the financial statements, if applicable, that describes the basis of presentation of the financial statements, including the country of origin of the accounting principles.
2. Report in accordance with another set of compilation or review standards provided that—
    a. the report would be issued by accountants in the other country in similar circumstances
    b. the accountant has obtained sufficient appropriate review evidence to support the conclusion in the report, if a review engagement is performed, and
    c. the accountant has complied with and identified the other compilation or review standards in the report.

When the compilation or review engagement is conducted in accordance with both the SSARS and another set of compilation or review standards, the report should refer to both the SSARS and the other set of standards and should identify the other set of standards and its origin. The report should not refer to having conducted the engagement in accordance with both the SSARS and another set of standards unless the engagement was conducted in accordance with both sets of standards in their entirety.

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 statements best describes the Accounting and Review Services Committee (ARSC)?

    a. It promulgates standards that are separate from those of the American Institute of Certified Public Accountants (AICPA).

    b. Its pronouncements are authoritative for practitioners who audit the financial statements of public entities.

    c. It has seven members who join via a nomination process and must be approved by the AICPA Board of Directors.

    d. It provides guidance to practitioners who audit and review the financial statements of issuers.

2. As of 2021, which of the following types of SSARS-related guidance is allowed even though none currently exist?

    a. Statements on Standards for Accounting and Review Services (SSARS).

    b. SSARS Interpretations.

    c. The AICPA SSARS Engagements Guide.

    d. Technical Questions and Answers (Q&A 9150).

3. What section of SSARS No. 21 covers review engagements?

    a. AR-C 60A.

    b. AR-C 70A.

    c. AR-C 80A.

    d. AR-C 90A.

4. SSARS No. 25 does which of the following?

    a. Explicitly require that accountants determine materiality for the financial statements as a whole and apply it when designing procedures and evaluating results.

    b. Requires that accountants withdraw from the engagement if there is evidence of pervasive and material misstatement of the financial statements.

    c. Eliminates the need for accountants to be independent with respect to an entity for which they issue a review report.

    d. Specifically clarifies that AR-C 90 is separate from International Standard on Review Engagements (ISRE) 2400 and outlines their differences.

5. AR-C 70 applies to financial statements that—

    a. will be submitted solely to taxing authorities.

    b. are prepared without issuing a report.

    c. are used as part of a pending legal proceeding.

    d. are used in a business valuation.

6. Assuming all other conditions are met, a compilation or review report for financial statements that will be used only outside of the United States can be issued in accordance with a set of compilation or review standards that are not the SSARS if which of the following is true?

   a. The report would not be issued in the other country under the same circumstances.

   b. The accountant has less review evidence than would be needed in the United States.

   c. The accountant complied with and identified other compilation or review standards in the report.

   d. The accountant should refer to both the SSARS and another set of compilation or review standards in the 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 in this lesson. **(References are in parentheses.)**

1. Which of the following statements best describes the Accounting and Review Services Committee (ARSC)? **(Page 288)**

    a. It promulgates standards that are separate from those of the American Institute of Certified Public Accountants (AICPA). [This answer is incorrect. ARSC has been designated by the AICPA Council to promulgate standards under ET Appendix A of the AICPA's *Code of Professional Conduct* (the Code).]

    b. Its pronouncements are authoritative for practitioners who audit the financial statements of public entities. [This answer is incorrect. The pronouncements of the ARSC represent the authoritative literature for CPAs when providing accounting and review services to nonpublic entities.]

    c. **It has seven members who join via a nomination process and must be approved by the AICPA Board of Directors. [This answer is correct. ARSC has seven members. The Director of the AICPA Audit and Attest Team nominates the ARSC Chair and in consultation with the ARSC Chair, nominates the other members of the ARSC. These nominations are approved by the AICPA Board of Directors.]**

    d. It provides guidance to practitioners who audit and review the financial statements of issuers. [This answer is incorrect. The Public Company Accounting and Oversight Board (PCAOB) Standards provide guidance to CPAs who perform audit or review services for issuers. ARSC's guidance is targeted for other types of practitioners.]

2. As of 2021, which of the following types of SSARS-related guidance is allowed even though none currently exist? **(Page 289)**

    a. Statements on Standards for Accounting and Review Services (SSARS). [This answer is incorrect. Currently, the ARSC has issued SSARS No. 1–25.]

    b. **SSARS Interpretations. [This answer is correct. Interpretations are issued to provide timely guidance on the application of SSARS. According to AR-C 60.07 (AR0C 60A.07), SSARS Interpretations are interpretative publications. They are not as authoritative as a SSARS, but CPAs should be aware that they are required to consider applicable interpretative publications when performing their SSARS engagements. Currently, there are no SSARS interpretations.]**

    c. The AICPA SSARS Engagements Guide. [This answer is incorrect. The AICPA Guide: *Preparation, Compilation, and Review Engagements* (AICPA Guide) is developed under the supervision and authority of the ARSC and is considered an interpretive publication pursuant to AR-C 60.07 (AR-C 60A.07). The 2020 version of the AICPA Guide is updated as of June 15, 2020. The 2021 version of the AICPA Guide is not expected to be available until the Fall of 2021, which is after the publication date of the course.]

    d. Technical Questions and Answers (Q&A 9150). [This answer is incorrect. Selected inquiries and replies by the staff of the Technical Information Services of the AICPA are published in the AICPA *Technical Questions and Answers*. Section Q&A 9150 of *Technical Questions and Answers* pertains to preparation, compilation, and review engagements. As of May 2020, a number of these nonauthoritative aids pertaining to SSARS have been issued.]

3. What section of SSARS No. 21 covers review engagements? **(Page 292)**

    a. AR-C 60A. [This answer is incorrect. AR-C 60A provides general principles for any engagements performed in accordance with the SSARS, not solely review engagements. It is intended to help accountants understand their professional responsibilities when performing SSARS engagements.]

b. AR-C 70A. [This answer is incorrect. AR-C 70A applies when an accountant is engaged to prepare financial statements but is *not* engaged to perform an audit, review, or compilation of those statements.]

c. AR-C 80A. [This answer is incorrect. AR-C 80A establishes the standards and provides guidance on *compilations* of financial statements, not reviews.]

d. **AR-C 90A. [This answer is correct. AR-C 90A establishes the standards and provides guidance on reviews of financial statements. The accountant is required to comply with the provisions of AR-C 90A whenever he or she is engaged to review financial statements, except for the reviews of interim financial information when AU-C 930 (AU-C 930B) applies.]**

4. SSARS No. 25 does which of the following? **(Page 296)**

a. **Explicitly require that accountants determine materiality for the financial statements as a whole and apply it when designing procedures and evaluating results. [This answer is correct. SSARS No. 25 makes explicit the requirement that the accountant should determine materiality for the financial statements as a whole and apply this benchmark when designing procedures and evaluating results. Such a requirement is already inherent in the extant standards because the accountant's review report concludes on whether the accountant is aware of any material modifications that would need to be made to the financial statements to comply with the applicable financial reporting framework.]**

b. Requires that accountants withdraw from the engagement if there is evidence of pervasive and material misstatement of the financial statements. [This answer is incorrect. SSARS No. 25 provides for an adverse conclusion in a review report when there is evidence of pervasive and material misstatement of the financial statements. Under the extant standards, the accountant's only recourse is to withdraw from the engagement.]

c. Eliminates the need for accountants to be independent with respect to an entity for which they issue a review report. [This answer is incorrect. SSARS No. 25 revises the accountant's review report to state that the accountant is required to be independent with respect to the entity and also to comply with ethical responsibilities under the relevant professional standards.]

d. Specifically clarifies that AR-C 90 is separate from International Standard on Review Engagements (ISRE) 2400 and outlines their differences. [This answer is incorrect. In February 2020, the ARSC issued SSARS No. 25. These amendments to the SSARS are a result of ARSC's project to *converge* AR-C 90, *Review of Financial Statements*, with ISRE 2400, *Engagements to Review Historical Financial Statements (Revised)*, and remove inconsistencies between the SSARS and the auditing standards with respect to concepts that should apply to all service levels.]

5. AR-C 70 applies to financial statements that— **(Page 299)**

a. will be submitted solely to taxing authorities. [This answer is incorrect. AR-C 70 (AR-C 70A) specifically does not apply when the accountant prepares financial statements to be submitted solely to taxing authorities.]

b. **are prepared without issuing a report. [This answer is correct. AR-C 70, *Preparation of Financial Statements* (AR-C 70A), allows accountants to prepare financial statements without issuing a report and does not limit the distribution of those statements. It applies when an accountant in public practice is engaged to prepare financial statements or prospective financial information but is not engaged to perform a compilation, review, or audit of those financial statements or prospective financial information.]**

c. are used as part of a pending legal proceeding. [This answer is incorrect. The preparation of financial statements used in conjunction with litigation services involving legal or regulatory proceedings, either pending or potential, are specifically excluded from AR-C 70 (AR-C 70A).]

d. are used in a business valuation. [This answer is incorrect. When an accountant prepares financial statements to be used in connection with business valuation services, AR-C 70 (AR-C 70A) does not apply.]

6. Assuming all other conditions are met, a compilation or review report for financial statements that will be used only outside of the United States can be issued in accordance with a set of compilation or review standards that are not the SSARS if which of the following is true? **(Page 305)**

   a. The report would not be issued in the other country under the same circumstances. [This answer is incorrect. Other standards can be used if, among other things, the report would be issued by accountants in the other country in similar circumstances. If the report would not be issued in the other country, issuing it in the United States would not be appropriate.]

   b. The accountant has less review evidence than would be needed in the United States. [This answer is incorrect. The report can only be issued using alternative standards if, among other conditions that must be met, the accountant has obtained sufficient appropriate review evidence to support the conclusion in the report, assuming a review engagement is performed. A lack of sufficient evidence would make issuing the report inappropriate.]

   c. **The accountant complied with and identified other compilation or review standards in the report. [This answer is correct. If the financial statements are intended for use in the United States, the accountant should follow the SSARS reporting requirements. If the financial statements are intended for use only outside the United States, however, the accountant has two options: reporting in accordance with SSARS or reporting in accordance with another set of compilation or review standards. The latter can only be chosen if certain conditions are met, one of which is that the accountant has complied with and identified the other compilation or review standards in the report.]**

   d. The accountant should refer to both the SSARS and another set of compilation or review standards in the report. [This answer is incorrect. When the compilation or review engagement is conducted in accordance with both the SSARS and another set of compilation or review standards, the report should refer to both the SSARS and the other set of standards and should identify the other set of standards and its origin. However, based on the scenario described above, reference to the SSARS would not be required.]

Lesson 2: Engagement Administration

INTRODUCTION

This lesson discusses concepts related to engagement administration and issues that may arise in this area when performing compilation and review engagements. It begins with a discussion of generation principles that apply to SSARS engagements, and then it takes a closer look at client acceptance and continuance; determining whether the SSARS apply to a particular engagement; recommending a level of service to the client; engagement letters; changing the type of engagement after the engagement has begun; subsequent events; the subsequent discovery of facts that existed at the date of the report; workpaper documentation; communication with other accountants; practice issues in these types of engagements; quality control, peer review, and ethics standards; other administrative forms; accounting software; independence issues; and how to deal with consultations and differences of opinion.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify general principles that apply to SSARS engagements, client acceptance and continuance considerations, whether the SSARS apply to a specific engagement, and how to recommend a level of service.
- Recognize how to deal with engagement letters, changing the engagement type, subsequent events, and the subsequent discovery of facts in compilation and review engagements.
- Determine best practices for workpaper documentation, communication with other accountants, and other practice issues in compilation and review engagements.
- Identify what quality control, peer review, and ethics standards apply to compilation and review engagements.
- Determine how accounting software, independence issues, consultations, and differences of opinion may affect compilation and review engagements.

GENERAL PRINCIPLES FOR SSARS ENGAGEMENTS

AR-C 60 (AR-C 60A, *General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services*), provides general principles for engagements performed in accordance with SSARS and is intended to help accountants understand their professional responsibilities when performing SSARS engagements. AR-C 60 (AR-C 60A) addresses the following general principles:

- Financial statements.
- Ethical requirements.
- Professional judgment.
- Conduct of the engagement in accordance with SSARS.
- Engagement level quality control.
- Acceptance and continuance of client relationships and engagements.

Financial Statements

According to AR-C 60.04 (AR-C 60A.04), the financial statements subject to the SSARS engagement are the entity's. That paragraph also clarifies that SSARS do not impose responsibilities on management; in addition, SSARS do not override laws and regulations that govern management's responsibilities.

Ethical Requirements

AR-C 60.08 (AR-C 60A.08) requires accountants to comply with all relevant ethical requirements when performing a SSARS engagement. Such ethical requirements include the fundamental principles of professional ethics as described in the AICPA *Code of Professional Conduct* (Code), and include principles relating to a member's responsibilities; the need to serve the public interest while maintaining integrity and objectivity; and the responsibility to perform the procedures with due care.

QC 10.21, *A Firm's System of Quality Control*, describes a firm's responsibilities to establish and maintain a quality control system for all SSARS engagements, including policies and procedures designed to provide the firm with reasonable assurance that the firm and its personnel will comply with relevant ethical requirements. Ethical requirements and a system of quality control that provides reasonable assurance that the firm complies with such requirements are both discussed in more detail later in this lesson.

Professional Judgment

AR-C 60.09 (AR-C 60A.09) requires the accountant to exercise professional judgment throughout the SSARS engagement. AR-C 60.A18–.22 (AR-C 60A.A17–.A21) contain additional guidance that may be useful in understanding how critical the exercise of professional judgment is to the performance of an engagement in accordance with SSARS. For instance, accountants use professional judgment when interpreting which ethical and legal requirements are relevant in a particular engagement. They also use it when making the many informed decisions required throughout that engagement. Only an accountant who has the appropriate training, knowledge, and experience can exercise professional judgment when making reasonable judgments and informed decisions about matters affecting the engagement. If difficult or contentious issues arise during the course of the engagement, consultations among engagement team members or others within or outside the firm also assist the accountant in making informed and reasonable judgments.

Exercising professional judgment in an individual engagement is based on the accountant's knowledge of the facts and circumstances, including—

- knowledge acquired during engagements performed in prior periods;
- the accountant's understanding of the entity and the industry in which it operates, its environment, its accounting system, and the application of its financial reporting framework; and
- the extent to which the exercise of judgment by either management or the accountant is required when preparing and presenting the financial statements.

Conduct of the Engagement in Accordance with SSARS

AR-C 60.10 (AR-C 60A.10) states that an accountant must perform an engagement to review, compile, or prepare financial statements in accordance with SSARS. This involves the following:

- *Complying with Each Requirement within All Relevant AR-C Sections.* An AR-C section is relevant to the engagement when it is in effect and the circumstances addressed in it exist. (If a particular requirement is not relevant in a specific engagement because it is conditional and the condition does not exist, the accountant does not have to comply with it.)
- *Understanding the Entire Text of a Relevant AR-C Section.* This includes understanding the related application and other explanatory material to enable the accountant to properly apply the AR-C sections' requirements and to satisfy the objectives of the relevant sections.

Defining Professional Responsibilities in SSARS. AR-C 60.15 (AR-C 60A.15) uses two specific terms to describe the degree of responsibility accountants have in complying with professional requirements:

- *Unconditional Requirements.* An accountant must always comply with an unconditional requirement if it is relevant to the engagement. SSARS use the word *must* to indicate an unconditional requirement.

- *Presumptively Mandatory Requirements.* An accountant must comply with a presumptively mandatory requirement if it is relevant to the engagement, except in rare situations discussed in AR-C 60.16 (AR-C 60A.16). SSARS use the word *should* to indicate a presumptively mandatory requirement.

If an AR-C section requires an accountant to consider whether a specific procedure should be performed or action taken, that procedure or action is presumptively mandatory. The accountant should determine whether to perform the procedure or action based on the accountant's consideration and professional judgment.

AR-C 60.16 (AR-C 60A.16) discusses the rare situations in which an accountant may determine that it is necessary to depart from a relevant presumptively mandatory requirement. Typically, these situations only arise when the requirement is for a specific procedure to be performed and, in the specific circumstances of the engagement, the accountant determines that the procedure would be ineffective in achieving the intent of the requirement. In such situations, the accountant is required to perform alternative procedures designed to accomplish the intent of the requirement.

In addition, when the accountant departs from the relevant, presumptively mandatory requirement, AR-C 60.17 (AR-C 60A.17) states the accountant must document both of the following:

- The justification for the departure.
- How the alternative procedures performed accomplished the intent of the requirement.

Relevant Interpretive Publications and Other Preparation, Compilation, and Review Publications. When performing a SSARS engagement, AR-C 60.18 (AR-C 60A.18) also states that the accountant should *consider* other relevant interpretive publications. While interpretive publications are not SSARS, they are issued under the authority of ARSC and present recommendations on how to apply SSARS in specific circumstances.

In addition, AR-C 60.19 (AR-C 60A.19) requires accountants to assess the relevance of other preparation, compilation, and review publications to the circumstances of the engagement. While these publications have no authoritative status, they may assist the accountant in understanding and applying the SSARS. Other preparation, compilation, and review publications that may be relevant in a SSARS engagement are listed in Lesson 1.

CLIENT ACCEPTANCE AND CONTINUANCE REQUIREMENTS

Statement on Quality Control No. 8, *A Firm's System of Quality Control* (QC 10), requires CPA firms to establish policies and procedures for the acceptance and continuance of client relationships and specific engagements. According to QC 10.27, the policies and procedures should be designed to provide reasonable assurance that the firm will undertake or continue relationships and engagements only when the firm—

a. possesses the competence and capabilities to perform the engagement, including the necessary time and resources, to do so;

b. complies with applicable legal and ethical requirements; and

c. considers the client's integrity and does not discover information that indicates a lack of integrity by the client.

AR-C 60.25–.26 (AR-C 60A.25–.26) provide guidance related to the accountant's responsibility with regard to the acceptance or continuance of client relationships and engagements performed under the SSARS. AR-C 60.A48 (AR-C 60A.A46) indicates that considerations related to client acceptance and continuance and compliance with relevant ethical requirements occur throughout the engagement as conditions and changes in circumstances occur. The accountant's performance of procedures on engagement acceptance and continuance and evaluation of relevant ethical requirements at the beginning of the engagement affect the accountant's decisions and actions before other significant procedures are performed.

SSARS No. 25 (AR-C 90.15) adds procedures if, after the engagement is accepted, the accountant is not satisfied that preconditions at AR-C 60.26 or AR-C 90.13 have been met. Those procedures require that the accountant discuss the matter with management to determine (1) whether the matter can be resolved, (2) whether it's

appropriate to continue the engagement, and (3) whether and how to communicate the matter in the accountant's report.

In today's environment, many lawsuits involving CPA firms occur because the firm associates with clients that lack integrity. CPA firms are often faced with difficult client acceptance and continuance decisions. On the one hand, since competition for clients is great, there is pressure to accept and continue relationships with all clients, even marginal ones. On the other hand, most firms recognize that scarce resources (such as personnel) should be dedicated to serving clients that are both profitable and unlikely to subject the firm to litigation risk.

For CPA firms, exposure to risk is often caused by poor decision-making about which clients to accept and keep. Faced with the opposing pressures of intense competition and the need to increase profitability while decreasing the risk of legal exposure, all firms—regardless of their size or the nature of their practice—can benefit from (and, as noted above, are required to establish) a formalized system to evaluate client acceptance and continuance.

One of the key factors in managing risk is understanding the risk associated with a new client or engagement before accepting the work. That understanding is essential for firms to determine whether the client relationship will be cost-beneficial. If the client is accepted, that advance understanding of the client also helps the firm properly assess the impact of risk on the engagement and the related procedures that may be necessary.

This section assists firms in making more informed client acceptance and continuance decisions and discusses some of the unique considerations when evaluating client acceptance and continuance in SSARS engagements.

Evaluating Firm Competence, Capabilities, and Resources

Deciding whether to accept or continue an engagement requires policies and procedures that guide the firm to determine whether it has personnel who possess the competence and capabilities and have scheduling availability to provide the desired services. QC 10.A11 offers the following matters to consider:

- Do firm members have, or are they able to acquire, the requisite industry or subject matter knowledge?
- Do firm members have, or are they able to acquire, the requisite experience with regulatory or reporting requirements?
- Are there sufficient competent and capable firm personnel available to staff the engagement?
- If specialists are needed, are they available?
- For applicable engagements, are there individuals qualified to perform an engagement quality control review?
- Can the firm meet the reporting deadline required by the engagement?

If the CPA firm believes that there is an integrity issue with a prospective client, the authors recommend that the firm not be associated with the client's financial statements or the client.

Compliance With Legal and Ethical Requirements

Another component when deciding whether to accept or continue an engagement requires the firm to develop policies and procedures to determine whether the firm can comply with the requisite legal and ethical requirements of the engagement.

Legal and Regulatory Requirements. Certain engagements may require a firm to comply with specific legal and regulatory requirements. Those requirements may apply as a result of the type of industry in which the client operates. For example, engagements that require the CPA to collect and examine the personal information of a client's customers, employees, or vendors may subject the accountant to federal and state privacy laws such as the Health Insurance Portability and Accountability Act (HIPAA) and the Gramm-Leach-Bliley Act. Also, many companies may be subject to Security Breach Notification Laws, which are in effect in a significant number of states.

Ethical Requirements. ET 0.300.050 of the Code requires that members in public practice be independent in fact and appearance, as well as maintain integrity and objectivity when performing professional services. In cases where it appears that a firm's independence, integrity, or objectivity is likely to be impaired, the firm should decline to accept an engagement. AR-C 60.25a (AR-C 60A.25a) states that the accountant should not accept a SSARS engagement if he or she will not be able to comply with relevant ethical requirements. A more detailed discussion of independence issues related to compilation and review engagements, including a discussion of the effects of accounting/write-up services on independence, and a discussion of the Code are provided later in this lesson.

Prospective Client's Integrity

Quality control standards also require CPA firms to establish policies and procedures to consider the client's integrity. SSARS engagements are typically performed for small businesses. One of the characteristics of a small business is concentration of ownership or operational control in one or a few individuals. This means that a primary consideration in client acceptance and continuance for a SSARS engagement is the general honesty and good faith of the owner/manager. However, the client includes various individuals such as the principal owners, key management, related parties, and those charged with governance. Consequently, the authors believe that the integrity of any individuals who have more than just a passing involvement with the business should be considered; for example, spouses of owners who are active in the business should be included in the evaluation. AR-C 60.25c (AR-C 60A.25c) states that the accountant should not accept a SSARS engagement if there is reason to believe doubts about management's integrity would affect the engagement.

Factors to Consider When Evaluating Integrity. When evaluating the integrity of the client, QC 10.A12 offers the following factors to consider:

- Both the identity and business reputation of the client's principal owners, key management, and those charged with its governance.
- Nature of operations and specific business practices of the client.
- Attitude of the client's principal owners, key management, and those charged with governance towards aggressive accounting and internal control matters.
- Inappropriate client limitation regarding the scope of work.
- Indications of the client's possible involvement in money laundering or other criminal activities.
- Reasons for the proposed appointment of the firm and dismissal of the previous firm.
- Length of the relationship with the client.

Sources of Information. There are no specific requirements in professional literature on the depth of an investigation of a client. However, sources of information may include—

a. Discussions with other CPAs in the community and other professionals—lawyers, bankers, etc.

b. Specific inquiry of the prospective client's lawyer and banker.

c. Inquiry of commercial credit agencies and business groups or associations, such as the Better Business Bureau.

d. Review of the prospective client's most recent interim or annual financial statements, income tax returns, and reports to regulatory agencies.

e. Specific inquiry of any former accountants who have provided services to the client.

f. A background check performed by an investigative firm.

Continuing Clients

For continuing clients, consider whether there are any significant changes in the following matters that would cause the firm to discontinue serving the client:

- Nature of the business,
- Ownership,
- Management,
- Issues involving client integrity,
- Financial condition,
- Earnings pressures,
- Conditions or events or operating results that are relevant to the going-concern assumption,
- Loan covenant compliance,
- Litigation status,
- Control environment or activities,
- Fraud risks,
- Management attitude toward, or pressures on, the accountants,
- Scope of the engagement,
- Other internal or external conditions, and
- Changes in independence.

Availability and Reliability of Information

AR-C 60.25b (AR-C 60A.25b) states that the accountant should not accept a SSARS engagement if his or her preliminary assessment of the engagement indicates that the information needed to perform the engagement will not be available or may be unreliable. The preliminary assessment should be documented. One method for doing so is by using the forms provided in *PPC's Guide to Compilation and Review Engagements*.

Significant Issues Discovered in the Acceptance or Continuance Process

If issues involving the acceptance or continuance of a client relationship or a specific engagement are identified and the firm decides to accept or continue the client relationship or the specific engagement, QC 10 requires that the firm document how the issues were resolved.

COVID-19 Considerations

The COVID-19 pandemic has drastically changed many facets of the environment, and affected how people function daily both at work and on a personal level. The significance of these changes has impacted how firms satisfy engagement performance requirements. For example, COVID-19 has altered most entities' operations, and thus, regardless of the type of engagement being performed, firms need to consider the entity's current operations as part of engagement planning and modify the engagement plan accordingly.

Though outside the scope of this course, *PPC's Guide to Compilation and Review Engagements* provides a list of some of the items to consider stemming from the effects of the COVID-19 pandemic when performing review and compilation engagements. The AICPA has not released new standards to respond to issues arising from COVID-19. However, the AICPA and other organizations have provided extensive nonauthoritative COVID-19 resources providing advice on dealing with the engagement issues created by COVID-19. AICPA resources can be found at

https://future.aicpa.org/resources/toolkit/aicpa-coronavirus-resource-center and Thomson Reuters resources can be found at **https://checkpoint.riag.com/**.

DETERMINING WHETHER THE SSARS APPLY TO A PARTICULAR ENGAGEMENT

Because the SSARS establish specific performance and communication requirements for preparation, compilation, and review engagements, it is necessary for the accountant to recognize when his or her services are governed by it.

Scope of the SSARS

Generally, any engagement for a *nonpublic entity* that involves *unaudited financial statements* is within the scope of the SSARS. An issuer that does not have its annual financial statements audited may engage an accountant to review its annual or interim financial statements in accordance with SSARS.

One exception to the basic scope of the SSARS is included in AR-C 90.02 (AR-C 90A.02) and applies to reviews of nonpublic entity interim financial information when all of the following conditions are met:

a. The entity's most recent annual financial statements have been audited by the accountant or a predecessor accountant.

b. The accountant either has been engaged to audit the entity's current year financial statements, or when it is expected that the current year financial statements will be audited, the appointment of another accountant to audit the current year financial statements is not effective prior to the period covered by the review.

c. The entity prepares its interim financial information using the same financial reporting framework as that used to prepare its annual financial statements.

In these instances, the accountant should perform the interim reviews in accordance with AU-C 930, *Interim Financial Information*. *PPC's Guide to Audits of Nonpublic Companies* discusses AU-C 930 reviews. That *Guide* also includes practice aids designed for use in interim reviews performed under AU-C 930.

Accounting Services

Over the last few years, many CPA firms' nonattest services practices have significantly grown in both fees and volume by providing firm employees who function as staff accountants, bookkeepers, controllers, and CFOs by performing various accounting services for the firm's clients. This growth is being driven by the following:

- Highly regulated industries need employees who know the regulations.
- Small businesses need employees who can perform multiple roles. Employees who excel at all of the tasks that are required of them are rare.
- Many small business owners do not have tremendous financial acumen.
- Clients have needed these services.
- The internet has allowed these services to be more easily provided remotely.

Much of the growth is from internal referrals. The firm often gives up the attest service engagement and performs the nonattest services, rather than trying to maintain their independence. The nonattest services are usually long term services that provide more value to the clients than the attest service would. The bulk of this work is generally done at the client location, but it may be provided through online services such as cloud computing. In many instances, the accountants become part of the management team. Many of these services are provided to nonprofit organizations, but may also be provided to credit unions, community banks, agricultural businesses, manufacturing/distribution companies, construction contractors, health care services, IT consultants, law firms, and dealerships.

In some instances, the CPA firm will do both the nonattest service and the attest service for a client. However, special precautions should be taken to ensure that independence is maintained. Nonattest services tend to be more cost

effective, generate higher gross revenue, and may provide (or be perceived to provide) more value to the clients than attest services. Although the gross margin is lower, the net is usually higher. The contracts that the CPA firms have with their clients for these nonattest services are usually month-to-month contracts; however, the relationships are usually long term. Clients who terminate the relationship are usually those who outgrow the need for such services and bring the work in house.

Examples of such services are as follows:

a. Preparing financial statements.

b. Performing merger and acquisition evaluations.

c. Preparing a working trial balance.

d. Processing payroll.

e. Assisting in adjusting the books of account.

f. Doing budgeting and forecasting.

g. Consulting on accounting, tax, and similar matters.

h. Serving as *de facto* board members.

i. Preparing tax returns.

j. Developing and maintaining banking relationships.

k. Providing various manual or automated bookkeeping or data processing services.

l. Helping with 401(k) plans.

m. Processing financial data for clients of other accounting firms.

n. Monitoring key business metrics.

The following paragraphs provide further discussion on a few of these accounting services.

Preparing a Working Trial Balance. In the course of providing accounting services to a client, the accountant sometimes supplies the client with a working trial balance. Though the provisions of the SSARS generally apply when the accountant prepares financial statements, they do not necessarily apply when the accountant prepares a trial balance. The Appendix at AR-C 70.A25 (AR-C 70A.A21) can assist accountants in determining whether the accountant is preparing financial statements or assisting in preparing financial statements. For example, the Appendix makes it clear that preparing or proposing adjustments, or entering general ledger transactions or processing payments in the accounting software system, do not make the accountant subject to the SSARS. The question then is, "How do you determine if a presentation is a financial statement or a trial balance?" Some of the attributes that help distinguish a trial balance from a financial statement are summarized as follows:

a. Financial statements group general ledger accounts to create single line items within the financial statement. Trial balances do not.

b. Financial statements include totals and subtotals such as current assets, total assets, total current liabilities, total liabilities, total equity, revenues, operating income, and net income. Trial balances do not.

c. Contra accounts, such as an allowance for bad debts, are netted against the related primary accounts in financial statements. In trial balances, they are not.

d. Financial statement titles generally reflect financial position, results of operations, or cash flows. Trial balance titles ordinarily include the term *trial balance* or indicate that the presentation is a listing of accounts.

e. Financial statements have numerous mathematical relationships. For example, total assets are equal to liabilities plus equity. The only mathematical relationship in trial balances is that total debits equal total credits.

f. Financial statements present assets and liabilities based on their liquidity and maturity. Trial balances present accounts based on their account number order.

g. Financial statements reflect results of operations, and net income is closed to retained earnings. Trial balances do not reflect results of operations, and the retained earnings balance is the balance as of the beginning of the period.

Tax Returns as Financial Statements. Financial presentations included in tax returns would not be considered financial statements according to the definition of *financial statements* in the SSARS [AR-C 60.07 (AR-C 60A.07)]. 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. In addition to income tax returns, information returns, such as Form 990 and Form 5500, are considered tax returns for purposes of the SSARS. The accountant is not precluded from complying with a request from a client to issue a compilation or review report on financial information contained in a tax return.

In some states, boards of accountancy rules may require that Form 990 and other tax returns used in lieu of financial statements be accompanied by a compilation report. If the accountant chooses to accept such an engagement, the accountant may follow the SSARS performance requirements to compile the financial information contained in the tax return and issue a compilation report.

Medicare/Medicaid Cost Reports as Financial Statements. Different ARSC committees have informally reached different conclusions at various times (and practice varies) as to whether third party reimbursement reports are subject to SSARS. In the authors' opinion, Medicare/Medicaid cost reports are not financial statements. Therefore, such reports are not governed by SSARS. Third party reimbursement reports are a government-required submission of financial and nonfinancial information, not financial statements. Those reports are signed by the client under penalties of perjury. The accountant may be engaged by the client to prepare the reports or to assist the client with report preparation similar to an engagement involving a tax return. Consequently, the authors believe that the guidance pertaining to tax returns discussed in the previous paragraphs also applies here.

Providing Automated Accounting Services without Preparing Financial Statements. As stated earlier, many accountants derive significant fees from providing automated accounting services to their clients. These services, often called write-up services, may include such items as the following:

- Recording cash receipts and disbursements, accruals, and adjustments to produce a general ledger or trial balance.
- Maintaining accounts receivable or accounts payable ledgers.
- Calculating depreciation and maintaining fixed asset registers.
- Processing payrolls.
- Calculating payroll tax deposits.
- Preparing payroll tax returns.
- Summarizing data required for tax returns.

As long as the accounting services do not include financial statements, the services are not included within the scope of the SSARS. The Appendix at AR-C 70.A25 (AR-C 70A.A21) lists maintaining depreciation schedules' preparing or proposing adjusting journal entries, and providing bookkeeping services as examples of services which are not financial statement preparation services and therefore not subject to AR-C 70 (AR-C 70A). Further guidance on write-up services can be found in *PPC's Guide to Write-up Services*. To order call (800) 431-9025 or access **tax.thomsonreuters.com**.

Engagement Driven

The SSARS are *engagement driven*. In other words, SSARS apply when an accountant in public practice is engaged to prepare, compile, or review the financial statements of a nonpublic entity. The SSARS may also be adapted to other historical or prospective financial information. Does this mean the accountant can provide the client with financial statements and not have to comply with the requirements of AR-C 70 (AR-C 70A, *Preparation of Financial Statements*), as long as they are not engaged to do so AR-C 70 (AR-C 70A) states that the determination of whether the accountant has been engaged to prepare the financial statements or to simply assist in preparing the financial statements is based on the services requested by the client and is a matter of professional judgment. The Appendix at AR-C 70.A25 (AR-C 70A.A21) can assist accountants in determining whether the accountant is preparing financial statements or assisting in preparing financial statements. The authors believe that accountants should not provide their clients with financial statements unless engaged to do so. AR-C 70 (AR-C 70A) was discussed in Lesson 1. As discussed later in this lesson, bookkeeping services can subject a firm to litigation risk. Engagement letters are one way to help manage litigation risk as they indicate the services which the accountant will provide. Due to these risk factors, the authors caution against preparing and providing financial statements to a client without complying with the requirements of AR-C 70 (AR-C 70A).

Specified Elements, Accounts, or Items of a Financial Statement

The SSARS address specified elements by saying that SSARS apply when the accountant is engaged to prepare, compile, or review an entity's financial statements; but may be adapted to other historical financial information. The application guidance at AR-C 70.A3 (AR-C 70A.A3), AR-C 80.A3 (AR-C 80A.A3), and AR-C 90.A2 (AR-C 90A.A2) lists specified elements, accounts, or items of a financial statement as other historical information.

MAKING A RECOMMENDATION ON THE LEVEL OF SERVICE

When clients need financial statements as part of an engagement, accountants may want to discuss certain engagement alternatives with their clients. For instance, unless a third-party user has specified either the level of service (preparation, compilation, or review) or the type of financial statements (with or without disclosures, GAAP or tax basis, etc.), clients may be able to select among several acceptable options. For example, they might engage the accountants to compile financial statements that omit substantially all disclosures, or they might ask them to prepare financial statements that conform to the cash basis of accounting. Generally, both of those options would result in lower costs than a compilation of full disclosure, GAAP financial statements. Of course, a review of financial statements generally will always be more costly than a compilation or preparation of financial statements. Given the cost variations, accountants should consider carefully the client's needs and the expected benefits of the service before suggesting a level of service.

The following paragraphs provide guidance on issues that might impact the accountants' recommendations about a level of service such as—

- Needs of users,
- Need for comparative financial statements,
- Alternatives to full disclosure GAAP financial statements,
- Independence, and
- Commissions, referral fees, and contingent fees.

Needs of Users

Most unaudited financial statements of nonpublic entities are prepared for one of three groups of users: management, owners, and banks or other creditors. The appropriate level of assurance for each user will, of course, vary with the circumstances. However, three generalizations can be made:

a. Financial statements prepared following the guidance in AR-C 70 (AR-C 70A) will usually be sufficient for management.

b. Owners who are not active in management probably prefer reviewed statements at least annually.

c. Banks and other creditors usually want as much assurance as they can get.

Needs of Management. When the financial statements are intended for management use, helping the client determine the best level of service is basically a matter of proper communication. The client tells the CPA what he thinks he wants; the CPA explains the differences in procedures, communications, and costs; the client asks the CPA for his view; the client selects the level of service. The accountant may be engaged to prepare financial statements and not report on those financial statements by following the guidance in AR-C 70 (AR-C 70A). (See the discussion of AR-C 70 (AR-C 70A) in Lesson 1.) In addition, clients can select among a number of alternative types of presentations. For instance, they might be able to choose between one or more of the alternatives to full disclosure GAAP financial statements discussed later in this section.

Needs of External Users. When banks or other creditors are involved, what is best for the client often becomes secondary to what is best for the creditor. In many cases, the CPA will be able to save the client unnecessary fees by properly explaining the differences between prepared, compiled, reviewed, and audited financial statements to the banker. When recommending a level of service, accountants also should keep in mind that they may be able to tailor the engagement to meet creditor needs. For instance, a banker whose loan is collateralized by accounts receivable may request an audit because he wants accounts receivable confirmed. However, if explained properly, the banker might accept reviewed financial statements or an agreed-upon procedures report (performed in accordance with SSAE No. 18) on accounts receivable. Another option would be to issue a compilation report on accounts receivable. All of these alternatives would undoubtedly save the client money. Q&A 9150.18 of the AICPA Technical Questions and Answers provides guidance in situations where a bank has requested that a CPA compile the balance sheet of another (nonclient) entity.

In other cases, the level of service to be performed is specified by an external user other than a bank or creditor. Certain state regulations, for instance, require common interest realty associations (CIRAs) to submit audited financial statements to applicable state regulatory authorities. Other states require that CIRAs submit reviewed statements. Are accountants responsible for determining the required level of service? The answer to this question, in the authors' opinion, is, "Absolutely not." Management is responsible for determining what level of service is required and engaging the accountants to perform that service. However, if the accountants become aware that the planned level of service does not meet relevant legal, regulatory, or contractual requirements, the authors believe the accountants should inform the client, and suggest that this communication be made in writing. If done orally, the authors believe the discussion should be documented in the engagement workpapers.

Need for Comparative Financial Statements

Presenting financial statements in comparative form with prior period financial statements generally enhances their usefulness. However, reporting on comparative financial statements can be somewhat complicated. Changes in level of service (i.e., 20X1 reviewed/20X2 compiled), and changes in accountants can create reporting problems that the accountant should evaluate before recommending comparative financial statements to his client.

AR-C 90.A133 (AR-C 90A.A87) states that the level of information for prior periods is comparable with the current period financial statements in comparative financial statements. The AICPA Guide, paragraph 2.54, states that financial statements that omit disclosures are not comparable to a period that includes disclosures. The SSARS allow substantially all disclosures to be omitted only for prepared or compiled financial statements. Thus, if the prior period financial statements were compiled and omitted substantially all disclosures, accountants have only two options for reporting on comparative financial statements that include the prior period statements:

a. Compile the current period financial statements and omit substantially all disclosures.

b. Recompile the prior period financial statements to include disclosures.

These considerations should also be evaluated before recommending a level of service (or setting a fee).

Alternatives to Full Disclosure GAAP Financial Statements

Clients need timely, accurate financial information to assist them in making business decisions. Some accountants believe that compiled GAAP financial statements are often not a cost-effective means of meeting a client's needs. Consequently, CPAs should examine the various alternatives to full disclosure GAAP financial statements. The following paragraphs include some of the alternatives currently available.

Providing Monthly Reports Containing Only Selected Financial or Operational Information. In some cases, clients may not need financial statements every month in order to make the decisions necessary to run their businesses. Instead, they may only need selected or summarized financial or operational information. This information may consist of account balances, such as sales, cash, or accounts receivables, operating information, such as labor utilization, average ticket per customer, number of units produced or sold, or a combination of both. As long as such information does not constitute a financial statement (a comparison of financial statement and trial balance attributes was provided earlier in this lesson), SSARS do not apply.

Preparing or Compiling Financial Statements That Omit Substantially All Disclosures. If a client does not feel that full disclosure statements are cost-effective, then the CPA may prepare or compile financial statements that omit substantially all of the disclosures required by GAAP or are ordinarily included in special purpose framework financial statements. The report should be modified to alert users to the lack of disclosures. The SSARS do allow accountants a nonreporting option if the guidance in AR-C 70 (AR-C 70A) is followed. For AR-C 70 (AR-C 70A) engagements, the omission of disclosures should be disclosed in the financial statements.

Compiling Special Purpose Framework Financial Statements. Many accountants find relief from some of the GAAP measurement and disclosure requirements by preparing financial statements using a financial reporting framework other than GAAP. In many cases, these financial statements will be less complex and require less time. For example, consider the preparation of cash-basis interim financial statements that omit substantially all disclosures. The financial statements should be relatively easy to prepare (that is, the accountant need only be concerned with *cash in* and *cash out*). The accountant's report generally would not change from period to period since only items representing departures from the cash basis would have to be disclosed in the report and such departures would be rare.

Compiling Financial Statements That Have Measurement Departures. Clients often do not consider it cost-effective to spend the time to adjust certain account balances (such as inventory, the accounts receivable allowance, depreciation expense, or deferred taxes), particularly in their interim financial statements. If a SSARS report is issued, all material departures should be listed in the report. Therefore, the report should state that the financial statements contain GAAP measurement departures, include a reference to the departures, and state that the effects of the departures have not been determined. (Note that the dollar effects of GAAP departures on the financial statements are only required to be disclosed in the report if they have been determined by management or are known as a result of the accountant's procedures.)

Some practitioners are concerned that this causes them to spend undue time listing departures in their report that (a) the client is already aware of and (b) are related to adjustments that the client has already determined to be unnecessary for its purposes. The rationale for disclosing the departures, however, is that there may be, and often are, users of the financial statements who would otherwise be unaware of the departures.

Many firms are able to minimize the time necessary to compile financial statements that have measurement departures by having standardized reports for interim financial statements that contain recurring measurement departures. Such reports are particularly effective when the client's financial statements have the same departures from one interim period to the next, which is often the case. For example, consider the situation where a client decides to accrue for bonuses only at year end and not at interim periods. In that situation, the CPA may draft, in advance, pro forma interim compilation reports listing the planned GAAP departure. This report may then be used for all interim periods.

Another important point to remember is that FASB ASC 270-10 permits the use of certain estimates in the preparation of interim financial statements. Consequently, even if the client can only reasonably estimate certain amounts in its interim financial statements, that may not constitute a material measurement departure, and disclosure in the accountant's report may not be necessary.

Independence

The only type of report a CPA can issue on financial statements when he or she is not independent is a compilation report. If the client needs reviewed financial statements, the CPA who is not independent should not perform the review service and might recommend another CPA to provide the review service. For many small businesses, the accountant serves as a primary business consultant and may unknowingly be providing services as part of the compilation or review engagement that impair his or her independence. Therefore, it is important for CPAs to understand the various rules and regulations that govern independence. The authoritative literature relating to independence is discussed later in this lesson, and some examples of client services or situations that might impair an accountant's independence are provided.

SELF-STUDY QUIZ

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

7. As a best practice, whose integrity should accountants be concerned with when deciding whether to accept a SSARS engagement with a small business?

    a. The owner.

    b. Management.

    c. Those charged with governance.

    d. Anyone with more than a passing involvement with the business.

8. Trial balances will do which of the following?

    a. Group general ledger accounts to create single line items.

    b. Include totals and subtotals, such as current assets and total assets.

    c. Net contra accounts against related primary accounts.

    d. Rely on a single mathematical relationship.

9. What type of financial statement user would likely have their needs met with annual sets of reviewed financial statements?

    a. Management.

    b. Owners who are not active in management.

    c. Banks and other creditors.

    d. This would likely be an appropriate level of service for all financial statement users.

SELF-STUDY ANSWERS

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

7. As a best practice, whose integrity should accountants be concerned with when deciding whether to accept a SSARS engagement with a small business? **(Page 317)**

    a. The owner. [This answer is incorrect. SSARS engagements are typically performed for small businesses. One of the characteristics of a small business is the concentration of ownership or operational control in one or a few individuals. This means that a primary consideration in client acceptance and continuance for a SSARS engagement is the general honesty and good faith of the owner/manager. However, even though this consideration is important, accountants should consider more than just the integrity of this one person before accepting the engagement.]

    b. Management. [This answer is incorrect. AR-C 60.25c (AR-C 60A.25c) states that the accountant should not accept a SSARS engagement if there is reason to believe doubts about management's integrity would affect the engagement. However, it would be a best practice for accountants not to limit their consideration of a prospective client's integrity only to management.]

    c. Those charged with governance. [This answer is incorrect. The client includes various individuals such as the principal owners, key management, related parties, and those charged with governance. Restricting consideration of integrity to only those charged with governance would not give accountants appropriate information to accept a SSARS engagement.]

    d. **Anyone with more than a passing involvement with the business. [This answer is correct. Quality control standards require CPA firms to establish policies and procedures to consider the client's integrity. This course suggests that, as a best practice, the integrity of any individuals who have more than just a passing involvement with the business should be considered; for example, spouses of owners who are active in the business should be included in the evaluation of a prospective client's integrity.]**

8. Trial balances will do which of the following? **(Page 320)**

    a. Group general ledger accounts to create single line items. [This answer is incorrect. Financial statements group general ledger accounts to create single line items within the financial statement. Trial balances do not.]

    b. Include totals and subtotals, such as current assets and total assets. [This answer is incorrect. Financial statements include totals and subtotals, such as current assets, total assets, total current liabilities, total liabilities, total equity, revenues, operating income, and net income. Trial balances do not.]

    c. Net contra accounts against related primary accounts. [This answer is incorrect. Contra accounts, such as an allowance for bad debts, are netted against the related primary accounts in financial statements. In trial balances, they are not.]

    d. **Rely on a single mathematical relationship. [This answer is correct. The provisions of the SSARS generally apply when an accountant prepares financial statements, but they do not necessarily apply when the accountant prepares a trial balance. Certain attributes can help distinguish financial statements from trial balances. One such attribute is that financial statements have numerous mathematical relationships. For example, total assets are equal to liabilities plus equity. The only mathematical relationship in trial balances is that the total debits equal total credits.]**

9. What type of financial statement user would likely have their needs met with annual sets of reviewed financial statements? **(Page 322)**

    a. Management. [This answer is incorrect. Financial statements prepared following the guidance in AR-C 70 (AR-C 70A) will usually be sufficient for management.]

    b. **Owners who are not active in management. [This answer is correct. Most unaudited financial statements of nonpublic entities are prepared for one of three groups of users: management, owners, and banks or other creditors. The appropriate level of assurance for each user will, of course, vary with the circumstances. However, certain generalizations can be made. One such generalization is that owners who are not active in management probably prefer reviewed financial statements at least annually.]**

    c. Banks and other creditors. [This answer is incorrect. Banks and other creditors usually want as much assurance as they can get. The CPA may be able to save the client unnecessary fees by properly explaining the differences between prepared, compiled, reviewed, and audited financial statements to the banker; however, reviewed financial statements will not always suffice.]

    d. This would likely be an appropriate level of service for all financial statement users. [This answer is incorrect. Because these three types of users all need different things from the financial statements, the appropriate level of service is not one-size-fits-all. CPAs need to consult with the client to find out who will be using the financial statements in order to determine the best level of service.]

ENGAGEMENT LETTERS FOR SSARS ENGAGEMENTS

Introduction

An engagement letter is required for all SSARS engagements.

Engagement Letters for Financial Statement Preparation Engagements

AR-C 70.10 (AR-C 70A.10) requires the accountant to agree upon the terms of the engagement with management or those charged with governance, as appropriate. The agreed-upon terms of the engagement should be documented in an engagement letter or other suitable form of written agreement, be signed by both the accountant or accountant's firm and management or those charged with governance, and include the following:

a. Objective of the engagement.

b. Responsibilities of management, as noted in AR-C 60.26b (AR-C 60A.26c).

c. Management's agreement that each page of the financial statements will include a statement indicating that no assurance is provided on the financial statements. (If that statement is not included, the accountant is required to issue a disclaimer that makes clear that no assurance is provided on the financial statements, perform a compilation engagement instead of a financial statement preparation engagement, or withdraw from the engagement.)

d. The responsibilities of the accountant.

e. Limitations of the engagement.

f. Identification of the applicable financial reporting framework to be used to prepare the financial statements.

g. Whether the financial statements are to (1) contain a known departure from the applicable financial reporting framework (including inadequate disclosure) or (2) omit substantially all disclosures required by the applicable financial reporting framework.

The requirement that SSARS engagement letters be signed by both parties is more extensive than the requirement for audit engagement letters. However, it is considered a best practice for audits. The engagement letter is essentially the contract for the engagement. Consequently, the authors recommend getting the engagement letter signed prior to beginning the work on the engagement.

AR-C 70.10 (AR-C 70A.10) permits the use of a written agreement other than an engagement letter to document the understanding with management. AR-C 70.A9 (AR-C 70A.A9) states that an oral understanding is not sufficient and that an engagement letter is the most common, and usually the most convenient, way to document the understanding with management regarding the services to be performed in connection with a financial statement preparation engagement. Therefore, the authors recommend that an engagement letter be used to document the agreement with management in a financial statement preparation engagement. Addressing the engagement letter is discussed later in this section.

As previously mentioned, one of the preconditions in AR-C 60 (AR-C 60A) to accepting a preparation engagement is that the accountant obtain management's agreement that it acknowledges and understands its responsibility for the SSARS preparation engagement. In a financial statement preparation engagement, management should acknowledge and accept its responsibility for the following:

a. Selecting the financial reporting framework to be used in preparing the financial statements.

b. Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error.

c. Preventing and detecting fraud.

d. Ensuring that the entity complies with applicable laws and regulations.

e. Ensuring the accuracy and completeness of records, documents, explanations, and other information, including significant judgments, that management provides for the preparation of the financial statements.

f. Providing the accountant with—

(1) access to all information that is relevant to the preparation and fair presentation of the financial statements, including records, documents, and other matters;

(2) additional information that the accountant may request from management for the purpose of the preparation engagement; and

(3) unrestricted access to individuals within the entity of whom the accountant decides to ask questions.

Engagement Letters for Compilation Engagements

AR-C 80.10–.11 (AR-C 80A.10–.11) requires the accountant to obtain and document a written agreement with the client regarding the services to be performed. The understanding with the client should be signed by both the accountant or the accountant's firm and management or those charged with governance and should include the following:

- The objectives of the engagement.
- The responsibilities of management, including management's responsibilities for—
  - the selection of the applicable financial reporting framework to be applied in the preparation of the financial statements.
  - the preparation and fair presentation of financial statements in accordance with the applicable financial reporting framework and the inclusion of all informative disclosures that are appropriate for the applicable financial reporting framework.
  - the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error.
  - the prevention and detection of fraud.
  - ensuring that the entity complies with the laws and regulations applicable to its activities.
  - the accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, provided to the accountant during the engagement.
  - providing the accountant with:
    - access to all information of which management is aware is relevant to the preparation and fair presentation of the financial statements.
    - additional information that may be requested by the accountant for the purpose of the compilation engagement.
    - unrestricted access to persons within the entity of whom the accountant determines it necessary to make inquiries.
  - including the accountant's compilation report in any document containing financial statements that indicate that the entity's accountant has performed a compilation engagement on such financial statements.
- The responsibilities of the accountant.
- The limitations of the compilation engagement.

- Identification of the applicable financial reporting framework to be used in the preparation of the financial statements.
- The expected form and content of the accountant's compilation report and a statement that there may be circumstances in which the actual report may differ from expectations.

If financial statement preparation services are performed as part of the compilation engagement, the accountant does not have to comply with the requirements of AR-C 70 (AR-C 70A). However, the accountant is required to comply with the requirements of ET 1.295 if he or she wishes to remain independent. ET 1.295 is discussed later in this lesson.

Engagement Letters for Review Engagements

AR-C 90.16–.17 (AR-C 90A.11–.12) requires the accountant to obtain a written agreement with the client regarding the services to be performed. SSARS No. 25 (AR-C 90.16) includes an explicit requirement to agree on the terms of the engagement prior to performing the engagement. The understanding with the client should be signed by both the accountant or the accountant's firm and management or those charged with governance, and should include the following:

- The objectives of the engagement.
- The responsibilities of management, including management's responsibilities for—
    - the selection of the applicable financial reporting framework to be applied in the preparation of the financial statements.
    - the preparation and fair presentation of financial statements in accordance with the applicable financial reporting framework and the inclusion of all informative disclosures that are appropriate for the applicable financial reporting framework.
    - the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error.
    - the prevention and detection of fraud.
    - ensuring that the entity complies with the laws and regulations applicable to its activities.
    - the accuracy and completeness of the records, documents, explanations, and other information, including significant judgments, provided to the accountant during the engagement.
    - providing the accountant with:
        - access to all information of which management is aware is relevant to the preparation and fair presentation of the financial statements.
        - additional information that may be requested by the accountant for the purpose of the review engagement.
        - unrestricted access to persons within the entity of whom the accountant determines it necessary to make inquiries.
    - providing the accountant, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.
    - including the accountant's review report in any document containing financial statements that indicate that the entity's accountant has performed a review engagement on such financial statements.
- The responsibilities of the accountant.

- The limitations of the review engagement, including a statement that a review is substantially less in scope than an audit and that the accountant will not express an opinion on the financial statements.
- Identification of the applicable financial reporting framework to be used in the preparation of the financial statements.
- The expected form and content of the accountant's review report and a statement that there may be circumstances in which the actual report may differ from expectations.

If financial statement preparation services are performed as part of the review engagement, the accountant does not have to comply with the requirements of AR-C 70 (AR-C 70A). However, the accountant is required to comply with the requirements of ET 1.295. ET 1.295 is discussed later in this lesson.

Engagement Letters When Reporting on Specified Elements

The SSARS say that they may be adapted for and applied to engagements related to other historical or prospective financial information. Specified elements, accounts, or items of a financial statement are listed as examples of other historical financial information to which SSARS may be applied.

Addressing the Engagement Letter

AR-C 70.10 (AR-C 70A.10), 80.10 (80A.10), and 90.16 (90A.11) state that the accountant should agree on the terms of the engagement with management or those charged with governance. Additionally, AR-C 70.A10 (AR-C 70A.A10), 80.A12 (80A.A12), and AR-C 90.A25 (90A.A19) state that depending on the entity's structure, the engagement letter may be addressed to management, those charged with governance, or both. However, when the engagement letter is addressed only to those charged with governance, the accountant is still required to obtain management's agreement that it acknowledges and understands its responsibilities, as listed in AR-C 60.26b (AR-C 60A.26c). Consequently, the authors recommend the engagement letter not be only addressed to those charged with governance. See the discussion of the AR-C 60.26b (AR-C 60A.26c) management responsibilities earlier in this lesson.

Period Covered by the Engagement Letter

When accountants document their understanding with the client via an engagement letter, do they need to obtain a new letter every year? Although the SSARS do not address that issue specifically, many accountants meet with their clients and update their engagement understandings at least annually. Doing so and documenting the understanding in an engagement letter ensures that it (a) reflects the scope of services the accountants are currently providing and (b) contains all legal protection clauses available to the accountants. Additionally, the Observations and Suggestions following Paragraphs 1.37 and 2.20 of the AICPA Guide reiterate that it is best practice to obtain an engagement letter at least annually. *PPC's Guide to Compilation and Review Engagements* provides illustrative engagement letters. If practitioners choose to use them, the generation of annual engagement letters requires little time.

Expected Form and Content of the Report

The SSARS require the engagement letter to include the expected form and content of the accountant's report and a statement that there may be circumstances in which the actual report may differ from expectations. This does not mean that the engagement letter must include the expected language of the entire report. In fact, the illustrative compilation engagement letters at AR-C 80.A51 (AR-C 80A.A47) contain only the following paragraph:

> As part of our engagement, we will issue a report that will state that we did not audit or review the financial statements and that, accordingly, we do not express an opinion, a conclusion, nor provide any assurance on them. Circumstances may arise in which it is necessary for us to modify our report or withdraw from the engagement.

The illustrative compilation engagement letters in *PPC's Guide to Compilation and Review Engagements* also address the requirements with a short paragraph by stating the following:

> As part of our engagement, we will issue a report that will state that we did not audit or review the financial statements and that, accordingly, we do not express an opinion, a conclusion, nor provide any assurance on them. There may be circumstances in which the report differs from the expected form and content. If, for any reason, we are unable to complete the compilation of your financial statements, we will not issue a report on such statements as a result of this engagement.

The illustrative GAAP review engagement letter at AR-C 90.A214 (AR-C 90A.A158) contains only the following paragraph:

> We will issue a written report upon completion of our review of ABC Company's financial statements. Our report will be addressed to the board of directors of ABC Company. We cannot provide assurance that an unmodified accountant's review report will be issued. Circumstances may arise in which it is necessary for us to report known departures from accounting principles generally accepted in the United States of America, add an emphasis-of-matter or other-matter paragraph(s), or withdraw from the engagement. If, for any reason, we are unable to complete the review of your financial statements, we will not issue a report on such statements as a result of this engagement.

The illustrative GAAP review engagement letters in *PPC's Guide to Compilation and Review Engagements* also address the requirements with a short paragraph by stating the following:

> We will issue a written report upon completion of our review of XYZ Company's financial statements. Our report will be addressed to the management of XYZ Company. We cannot provide assurance that an unmodified accountant's review report will be issued. Circumstances may arise in which it is necessary for us to report known departures from accounting principles generally accepted in the United States of America, add an emphasis-of-matter or other-matter paragraph(s), or withdraw from the engagement. If, for any reason, we are unable to complete the review of your financial statements, we will not issue a report on such statements as a result of this engagement.

The authors believe that the Our Report section of the compilation engagement letter should include a discussion of the lack of independence and/or the omission of substantially all disclosure if the accountant expects that he or she will not be independent or that substantially all disclosures will be omitted. In addition, if supplementary information will be included with either compiled or reviewed financial statements, the authors believe that the Our Report section of the respective engagement letter ought to identify the supplementary information and state the responsibility the accountant plans to take for such supplementary information. Language that may be used for these scenarios is included in the practical considerations of the illustrative engagement letters in *PPC's Guide to Compilation and Review Engagements*.

Using Engagement Letters to Minimize Liability

If an accountant does not comply with the SSARS in a financial statement preparation, compilation, or review engagement, a client may be successful in recovering damages suffered based on the accountant's actions under contract or tort law. According to tort law concepts, the client may be successful in suing the accountant if he can establish fraud, constructive fraud, or negligence.

One way to minimize liability is through the engagement letter. The engagement letter is an invaluable loss prevention/loss mitigation measure. When a dispute arises between the accountant and the client regarding services for which the client has contracted, the burden of proof is on the accountant to prove that the agreement was for a lower service (compilation and review), not an audit. A signed engagement letter serves as documentation that the client understood the level of service to be provided by the CPA.

Much of the language included in the illustrative engagement letters in *PPC's Guide to Compilation and Review Engagements* was written to minimize the CPA's liability in compilation and review engagements. For example, the illustrative engagement letters contain the following sentence:

> Our engagement cannot be relied upon to identify or disclose any financial statement misstatements, including those caused by error or fraud, or to identify or disclose any wrongdoing within the entity or noncompliance with laws and regulations.

This sentence clarifies the accountants' extremely limited responsibility for detecting fraud in a SSARS engagement.

In the illustrative review engagement letters, that same paragraph goes onto say:

> However, we will inform the appropriate level of management of any material errors and any evidence or information that comes to our attention during the performance of our review procedures that indicates fraud may have occurred. In addition, we will inform you of any evidence or information that comes to our attention during the performance of our review procedures regarding noncompliance with laws and regulations that may have occurred, unless they are clearly inconsequential.

This additional language clarifies the accountants' responsibility for communicating errors, fraud, and noncompliance with laws and regulations to their clients. Specifically, accountants agree to inform their clients of all material errors or fraud that come to their attention during the course of their engagement, and they agree to communicate only noncompliance with laws and regulations that come to their attention if they are considered consequential. In other words, accountants have no responsibility to communicate noncompliance with laws and regulations that is consider to be clearly inconsequential. The authors believe the term *clearly inconsequential* refers to an amount that is so obviously immaterial that its insignificance cannot be questioned. The authors caution, however, that accountants should consider more than the quantitative amounts involved since some acts or occurrences may indicate a potential for other noncompliance with laws and regulations. In summary, the accountant is not required to communicate clearly inconsequential matters, but if there is doubt about the consequence of a matter, the authors recommend that it be communicated.

The illustrative engagement letters for reviews also contain language that clarifies the accountants' responsibility for internal control while describing the review service:

> A review engagement does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents; or other procedures ordinarily performed in an audit engagement.

Using the guidance in ET 1.228.010 of the Code, "Indemnification of a Covered Member," and in the SSARS, the accountant may include a clause such as the following in a SSARS engagement letter:

> You agree to hold us harmless and to release, indemnify, and defend us from any liability and costs, including attorney's fees, resulting from management's knowing misrepresentations to us.

This clause, included in the illustrative engagement letters in *PPC's Guide to Compilation and Review Engagements*, is acceptable, and will not impair independence, provided that it is restricted to "knowing misrepresentations." However, if the indemnification clause includes *any* misrepresentation, which includes negligent misrepresentations, the CPA firm's independence would be impaired and the firm could not issue a review report but may issue a compilation report, provided that the lack of independence is properly disclosed.

The AICPA Professional Ethics Executive Committee (PEEC) issued ET 1.400.060, "Indemnification and Limitation of Liability Provisions," of the Code to remind practitioners that some regulators (including the SEC) prohibit the use of indemnification and limitation of liability provisions. Failure to comply with a regulator's requirements on the use of indemnification and limitation of liability provisions is considered an act discreditable to the profession. In addition, these provisions, if used when prohibited, would cause the CPA firm to not be independent.

Additional Engagement Letter Provisions for Limiting a Firm's Liability

There are a number of additional provisions that CPAs may want to add to their engagement letters. The use of some of these provisions is becoming common. They can be very effective at limiting a firm's legal liability and assisting a firm to resolve client disputes in a cost-effective manner. Those additional provisions are discussed in the following paragraphs.

The authors recommend that accountants consult their legal counsel and insurance carrier when assessing language in the engagement letter intended to limit exposure to legal liability.

Undertaking-to-be-truthful Clauses. An engagement letter clause that can be helpful in litigation is an agreement by the client to be truthful, accurate, and complete in making representations to the firm. The following are examples of this type of clause:

> You acknowledge that as a condition of our agreement to perform a review, you agree to the best of your knowledge and belief to be truthful, accurate, and complete in the representations you make to us during the course of the review and in the written representations provided to us at the completion of the review.
>
> or
>
> You acknowledge that as a condition of our agreement to perform a compilation, you agree to the best of your knowledge and belief to be truthful, accurate, and complete in the representations you make to us during the course of the compilation.

If a client brings an action against a CPA firm alleging malpractice and breach of contract, in some states the firm would be able to defend the breach of contract claim if the client had breached its duty to provide truthful, accurate, and complete representation. This defense could be asserted at the outset of the litigation via a motion to dismiss. In some states, a misrepresentation, however, would not necessarily provide a defense to the client's malpractice claim unless it could be shown that the client's misrepresentation actually interfered with the firm's performance of its procedures. This defense, however, would probably not be successful on a motion and would have to be asserted at trial.

A representation letter obtained from the client at the end of the review may not be regarded as a substitute for an undertaking-to-be-truthful clause in the engagement letter. The engagement might be terminated before a representation letter is obtained and the client's attorney might argue a representation letter was not a condition of the engagement.

Alternative Dispute Resolution. Alternative dispute resolution (ADR) is a popular way of attempting to resolve client disputes without exposing the firm to the cost and uncertainty of litigation. ADR may take less time than litigation and provides a better chance of preserving the client/accountant relationship. ADR techniques apply primarily to client disputes (for example, fee disputes) rather than third-party claims because the engagement letter is a two-party contract and does not bind third-party users.

Arbitration closely resembles litigation and is usually presided over by a panel comprised of one or more persons who may or may not be attorneys. Many CPA firms prefer to have an arbitration panel include at least one CPA. In an arbitration, the parties present their respective cases to an arbitrator (or panel of arbitrators) who renders a verdict at the conclusion of the case. The arbitrator acts as both judge and jury by making evidentiary rulings, ordering discovery, and imposing sanctions in addition to deciding the issues in the case.

While arbitration may represent an attractive alternative to litigation, it has some significant drawbacks. First, arbitrators sometimes tend to simply split the difference between the two parties' claims. Second, there is no guarantee that a client who does not like the arbitrator's decision cannot have it overturned in court. Third, and most importantly, a firm's agreement, without the consent of its insurance carrier, to submit to binding arbitration may limit the insurer's ability to defend the case and void the firm's insurance coverage for that claim. Before adding language regarding arbitration or other alternative dispute resolution methods to engagement letters, accountants may consult with their attorney and obtain a written consent from their insurance carrier.

Another well-known ADR technique is mediation. While mediation is often discussed along with arbitration, it is a vastly different process. In mediation, no resolution is imposed on the disputing parties by a neutral party. Instead, mediation is little more than voluntary settlement negotiations facilitated by a neutral party. If mediation works, it can be an expeditious and cost-effective way of resolving disputes.

Mediation frequently succeeds when direct bilateral negotiations between the parties fail. Mediation has certain advantages:

- The parties are brought into the settlement discussions so they can hear first-hand (not through their attorneys) the strengths and weaknesses of their opponent's case.
- The discussion takes place in a controlled atmosphere that prevents the parties from storming out of the discussions at the first sign of disagreement.
- Mediations are not about winning or losing, but rather about finding a resolution that is better than the result likely to be achieved through litigation.
- By communicating through the mediator, the parties are able to reach compromises that are not possible where neither party is willing to blink first for fear of showing weakness.

Because mediation is about reaching agreement and because the parties spend little time together in face-to-face meetings, there is an opportunity for the parties to resolve their differences without feeling that they have to reveal their strengths and weaknesses to the other party.

The principal weakness of mediation is that it does not always resolve the claim. The following language can be inserted into an engagement letter to provide for use of an alternative dispute resolution method applicable if there is a dispute with a client.

> If any dispute, controversy, or claim arises, either party may, upon written notice to the other party, request that the matter be mediated. Such mediation will be conducted by a mediator appointed by and pursuant to the Rules of the American Arbitration Association or such other neutral facilitator acceptable to both parties. Both parties will exert their best efforts to discuss with each other in good faith their respective positions in an attempt to finally resolve such dispute or controversy.
>
> Each party may disclose any facts to the other party or to the mediator which it, in good faith, considers necessary to resolve the matter. All such discussions, however, will be for the purpose of assisting in settlement efforts and will not be admissible in any subsequent litigation against the disclosing party. Except as agreed by both parties, the mediator will keep confidential all information disclosed during negotiations. The mediator may not act as a witness for either party in any subsequent arbitration between the parties.
>
> The mediation proceedings will conclude within sixty days from receipt of the written notice unless extended or terminated sooner by mutual consent. Each party will be responsible for its own expenses. The fees and expenses of the mediator, if any, will be borne equally by the parties.
>
> If any dispute, controversy, or claim cannot be resolved by mediation, then the dispute, controversy, or claim will be settled by arbitration in accordance with the Rules of the American Arbitration Association (AAA) for the Resolution of Accounting Firm Disputes. No prehearing discovery will be permitted unless specifically authorized by the arbitration panel. The arbitration hearings will take place in the city closest to the place where this agreement was performed in which the AAA maintains an office, unless the parties agree to a different locale.
>
> The award issued by the arbitration panel may be confirmed in a judgment by any federal or state court of competent jurisdiction. All reasonable costs of both parties, as determined by the arbitrators, including (1) the fees and expenses of the AAA and the arbitrators and (2) the costs, including reasonable attorneys' fees, necessary to confirm the award in court, will be borne entirely by the non-prevailing party (to be designated by the arbitration panel in the award) and may not be allocated between the parties by the arbitration panel.

> Such arbitration shall be binding and final. In agreeing to arbitration, we both acknowledge that in the event of a dispute over fees charged by the accountant, each of us is giving up the right to have the dispute decided in a court of law before a judge or jury and instead we are accepting the use of arbitration for resolution.

Specifying a Time Limitation. Some CPA firms have attempted to limit their liability exposure by including a provision requiring that all claims, with respect to services, be asserted within a specified period of time, such as one year from the date the subject services were performed. This limitation provision may protect the firm from a substantial portion of claims arising out of fraud as well as frivolous counter-claims in the event that the firm is required to sue a client for unpaid professional fees. A sample of this provision follows:

> Because there are inherent difficulties in recalling or preserving information as the period after an engagement increases, you agree that, notwithstanding the statute of limitations of the State of _[Fill in client's state of domicile.]_ , any claim based on this engagement must be filed within _[12]_ months after performance of our service, unless you have previously provided us with a written notice of a specific defect in our services that forms the basis of the claim.

Clients are likely to resist this clause and the firm will need to balance the length of the statute of limitations, when the statute begins to run, and the type of services performed against the use of this provision. This clause, to be effective, should be coupled with a clause in the engagement letter that sets forth when the engagement begins and when the engagement ends. The ability to shorten the statute of limitations is governed by state law, and certain states prohibit the shortening of a statute of limitations in a professional liability context. This combination of clauses may be used to defeat a "continuous representation" argument by the plaintiff. Recently, two New York State court cases have upheld that a continuous representation argument does not pause or delay the period of time set forth by a contractually agreed-upon limitations provision. This is an important development, and it is not clear yet whether courts in other states will follow.

A Federal Reserve Board advisory prohibits financial institutions from entering into engagement letters that limit the CPA's liability for claims. *PPC's Guide to Audits of Financial Institutions* includes a discussion about the advisory.

Considerations When Using Engagement Letter Clauses. If a CPA firm wishes to utilize any of the preceding clauses to limit its liability, the firm should consult its legal counsel and its insurance carrier. In addition, it is important that the client take note of the clauses before signing and returning the engagement letter. Otherwise, there is a danger that the courts may be unwilling to enforce the provisions. This means the CPA firm either point out such clauses to the client when the engagement letter is delivered or type such clauses in bold print and/or capital letters so that they will stand out from the remainder of the engagement letter.

Informing Clients of Outsourcing Arrangements

The authors believe it will be rare for accounting firms to outsource portions of compilation or review engagements. However, firms often will outsource other services which might be covered by their compilation or review engagement letter, such as tax services. ET 1.150.040 of the Code requires that clients be informed, preferably in writing, if the practitioner's firm will outsource professional services to third-party service providers. If the practitioner intends to use third-party service providers (that is, entities not controlled or employed by the accounting firm), the client should be informed before confidential client information is shared with the service provider. Also, ET 1.700.040 of the Code requires a contractual agreement between the accounting firm and the service provider to maintain the confidentiality of client information. The contractual agreement should provide the accounting firm with reasonable assurance that the service provider has procedures in place to prevent the unauthorized release of confidential information. If the firm does not have a contractual agreement with the service provider, the firm should obtain specific consent from the client before disclosing confidential information to the service provider.

In cases where the practitioner chooses to provide written disclosure that a third-party service provider will be used, the following paragraph may be included in the engagement letter.

> We may from time to time, and depending on the circumstances, use third-party service providers in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information.

> Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third-party service provider. Furthermore, we will remain responsible for the work provided by any such third-party service providers.

MAKING CHANGES IN TYPE OF ENGAGEMENT AFTER COMMENCEMENT

Occasionally, during the course of a financial statement engagement (audit, review, or compilation), the CPA may be requested by the client to change the nature of the engagement. The request may be either for a *step-up* in the level of service, e.g., compilation to review, review to audit, or a *step-down* in the level of service, e.g., audit to review, review to compilation. A change in the type of engagement may also involve a compilation with disclosures to a compilation without disclosures.

Step-ups

The SSARS do not specifically address step-ups. Although a change to a higher level of service is always voluntary, it harbors no dangers for the CPA as long as the engagement is completed according to the standards appropriate for the eventual level of service agreed upon. With this in mind, the CPA should (a) determine what additional procedures and standards are required for the level of service requested, (b) determine whether it is possible and practical to perform the procedures and comply with the standards, and (c) revise the understanding of the engagement if the type of service is changed.

Step-down from Audit or Review or Compilation to Review or Compilation or Preparation

AR-C 90.A204 (AR-C 90A.A148) and Paragraph 2.92 of the AICPA Guide list three reasons that might cause a client to request a change in the level of service after an audit or review engagement has begun:

a. A change in circumstances affecting the entity's requirement for an audit or review.

b. A misunderstanding as to the nature of an audit or review, or the alternative review and compilation services originally available.

c. A restriction on the scope of the audit or review, whether imposed by the client or caused by circumstances.

Occasionally, the requirement for audited or reviewed or compiled statements is removed after an engagement begins. For example, an audit of an interim period started as a result of acquisition negotiations is aborted when the negotiations collapse, or a line-of-credit is reduced to a level that no longer requires audited or reviewed financial statements under the bank's policy. Agreeing to a step-down in the level of service is generally acceptable in such circumstances.

A misunderstanding of the nature of the various services available is also an acceptable reason for a step-down in level of service. However, misunderstandings can cause other problems (particularly fee problems), and the CPA should try to avoid them. Every practitioner should make audit clients aware of the limited assurance report (review report), the nonassurance report (compilation report), the financial statement preparation non-reporting option, and reexamine the reasons for the engagement before the engagement begins.

The implications of a restriction on the scope of the audit or review should be considered carefully, including the possibility that information affected by the scope restriction may be incorrect, incomplete, or otherwise unsatisfactory. If the accountant has such concerns after considering the circumstances of the scope restriction, he should not agree to issue a report based on a lower level of service. AU-C 210.17 includes auditor's responsibilities when it is determined there is no reasonable justification for a change in the terms of an audit engagement or if the auditor is not permitted to continue the audit engagement.

AR-C 90.136 (AR-C 90A.93) ordinarily precludes an accountant from agreeing to a step-down from an audit when the accountant has been prohibited from corresponding with the entity's legal counsel for purposes of obtaining evidence on litigation, claims, and assessments. And, although written representations are not specifically addressed in the SSARS step-down discussion, AR-C 90.63 (AR-C 90A.37) says the accountant should withdraw from the engagement if management does not provide the required representations. Consequently, a step-down would not be appropriate.

AR-C 90.133 (AR-C 90A.90) states that, regardless of the reason for the request for a step-down from an audit, the accountant should consider the propriety of a step-down if the cost to complete the audit is relatively insignificant.

If, after considering the circumstances, the accountant agrees to a step-down from an audit or review to a compilation or review, he should follow the guidance in AR-C 90.135 (AR-C 90A.92) and Paragraph 2.97 of the AICPA Guide when drafting the accountant's report. The accountant is precluded from making reference in the report to the following items:

a. The original engagement.

b. Any audit or review procedures that may have been performed.

c. Scope limitations that resulted in the changed engagement.

Step-downs to financial statement preparation engagements are not specifically addressed in the SSARS or in the AICPA Guide. However, the authors believe that such a step-down may be acceptable in certain situations and that the guidance provided above is good guidance for any step down.

Step-down from Full Disclosure to Omission of Substantially All Disclosures

A step-down in the level of service might involve a request that substantially all disclosures be omitted. The accountant can agree to such a request only if, in the accountant's professional judgement, the omission of disclosures would not mislead those who might reasonably be expected to use the statements. Since it is inappropriate to issue reviewed statements that omit substantially all disclosures, the accountant should explain to the client that the accountant will not be able to issue a review report (express limited assurance), even if the engagement included inquiry and analytical procedures.

When a CPA receives a request to step-down to statements that omit substantially all disclosures, the CPA should not only seek to ascertain whether the omission is undertaken with the intention of misleading, but also *document* any findings before agreeing to compile such statements. If such statements were, in fact, misleading and the accountant were sued, failure to follow up on a clue such as the client's request for a step-down in service could likely be damaging.

CONSIDERATIONS FOR SUBSEQUENT EVENTS

The period between the balance sheet date and management's issuance of the financial statements is called the *subsequent period*. Subsequent period events or transactions that have a material effect on the financial statements require adjustment or disclosure in the statements. Evidence or information that a subsequent period event or transaction that has a material effect on the financial statements has occurred may come to the accountant's attention—

- During the performance of the compilation or review procedures.
- After the date of the accountant's compilation or review report, but prior to releasing the accountant's report.

In either instance, the accountant should ask management to consider the possible effects the event or transaction might have on the financial statements, including any related disclosure (if disclosures are included). AR-C 90.29f (AR-C 90A.22f) specifically states that as part of the accountant's review procedures, the accountant should inquire of management concerning material subsequent events. Information on such subsequent events should be included in the management representation letter.

FASB ASC 855-10-50-1 requires nonpublic entities whose financial statements include disclosures to disclose the date through which subsequent events have been evaluated and whether that date is the date the financial statements were issued, or the date the financial statements were available to be issued. GAAP requires that a nonpublic entity shall evaluate subsequent events through the date that the financial statements are available to be issued.

FASB ASC 855, *Subsequent Events*, does not change the accountant's responsibilities under the SSARS for subsequent events in compilation and review engagements. The SSARS state that an accountant performing a review engagement should inquire of members of management who have responsibility for financial and accounting matters concerning events subsequent to the date of the financial statements that could have a material effect on the financial statements. In a compilation engagement, the accountant does not have any responsibility with respect to subsequent events unless evidence or information comes to an accountant's attention that a subsequent event that has a material effect on the financial statements has occurred. When such evidence or information comes to an accountant's attention during a compilation or review engagement, the accountant should request that management consider the possible effects on the financial statements, including the adequacy of any related disclosure. If the accountant determines that the subsequent event is not adequately accounted for in the financial statements or adequately disclosed in the notes, the accountant should follow the guidance for GAAP departures.

Occasionally, a subsequent event has such a material impact on the entity that the accountant may wish to include an explanatory paragraph about the event in the accountant's report. Such an explanatory paragraph is not required, but may be added at the accountant's discretion, provided the matter is disclosed in the financial statements.

Types of Subsequent Events

FASB ASC 855-10 includes accounting guidance on subsequent events. There are two types of subsequent events that are often given the short-hand labels of Type I and Type II events:

a. *Type I (recognized subsequent events).* The first type consists of events that provide additional evidence about conditions that existed at the balance sheet date and that affect the estimates inherent in preparing financial statements. The proper accounting treatment of these events is *adjustment* of the financial statements. Subsequent events that affect the realization of assets (e.g., receivables and inventories) or the settlement of estimated liabilities (e.g., product warranty reserves) ordinarily should be adjusted for in the financial statements. Exceptions to this presumption to adjust are changes in the quoted market price of securities because such changes typically are caused by current conditions and events that clearly did not exist at the balance sheet date. Also, settlement of litigation that arose from an event after the balance sheet date or a receivables loss resulting from a customer's major casualty (e.g., fire or flood) after the balance sheet date would not require adjustment.

b. *Type II (nonrecognized subsequent events).* The second type consists of events that did not exist at the balance sheet date but that arose after the balance sheet date but before the financial statements are issued or are available to be issued. Some *nonrecognized subsequent events* may require disclosure to keep the financial statements from being misleading. If disclosure is required, an entity should disclose the nature of the event and an estimate of its financial effect, or a statement that such an estimate cannot be made. Examples of these events include—

   (1) Sale of a bond or capital stock issue.

   (2) Purchase of a business.

   (3) Loss of plant or inventories caused by natural disaster.

Reissued Financial Statements

As noted at FASB ASC 855-10-25-4, when financial statements are reissued, events that require disclosure in the reissued financial statements to keep them from being misleading may have occurred subsequent to the original issuance of the financial statements. Events occurring between the time of original issuance and reissuance of the financial statements should not result in adjustment to the financial statements unless required by GAAP or regulatory requirements.

THE SUBSEQUENT DISCOVERY OF FACTS THAT EXISTED AT DATE OF REPORT

Subsequent to the date of the accountant's compilation or review report, the accountant may become aware of facts that existed on that date that might have caused him or her to believe that information supplied by the entity was incorrect, incomplete, or otherwise unsatisfactory had the accountant then been aware of them. AR-C 90.49–.57 (AR-C 90A.72–.78) addresses the accountant's performance requirements for subsequent discovery of facts. Paragraphs 1.210–.216 of the AICPA Guide reiterate those requirements from AR-C 90 (AR-C 90A). Neither the AICPA Guide or AR-C 80 (AR-C 80A) address subsequent discovery of facts in a compilation engagement. However, the authors believe the guidance in AR-C 90 (AR-C 90A) summarized below is good guidance that may be followed in compilation engagements as well.

Legal Implications

Because of the legal implications involved, the accountant would be well advised to consult his or her legal counsel and insurance provider.

Summary of Guidance

The guidance in the SSARS can be summarized as follows:

a. If the information that the accountant becomes aware of is of such a nature and from such a source that the CPA would have investigated it had it come to his attention during the engagement, he should investigate it as soon after it comes to his attention as is practical. In a preparation or compilation engagement, that investigation consists of obtaining additional or revised information. In a review engagement, that investigation consists of performing the additional procedures deemed necessary to achieve limited assurance that there are no material modifications that should be made to the financial statements to be in conformity with generally accepted accounting principles.

b. If, after investigation, the CPA determines that (1) his or her report or the financial statements would have been affected if the information had been known to him or her at the date of the report and (2) he or she believes there are persons currently relying on, or likely to rely on, the financial statements who would attach importance to the information, the CPA should advise his or her client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are relying on the financial statements and the related accountant's report.

c. The method of disclosure by the client might, depending upon the circumstances, take one of the following forms:

   (1) Issuance of revised financial statements and the accountant's report. The reasons for the revision should usually be described in a note to the financial statements referred to in the accountant's report.

   (2) Disclosure of the revision in subsequent financial statements instead of reissuing the earlier statements.

   (3) Notification to the users of the statements that they should not be relied upon and that revised statements will be issued upon completion of an investigation.

d. If the client refuses to make the requested disclosures, the CPA should notify the chair of the board of directors and other appropriate board members, such as the audit committee chair (or owners, if the company has no board of directors), of the client's refusal, and take appropriate steps to prevent future reliance upon the report. In some cases, the accountant may choose to notify all board members.

Even if the decision is made to issue revised financial statements and accountant's report, many practical aspects of that decision remain vague. For example, how should the accountant ensure that all financial statement users have been notified? Should the new report contain a paragraph disclosing the revision? How should the new report be dated? Notification of users is discussed in the following paragraph. Though outside the scope of this course, an in-depth discussion on correcting an error is provided in *PPC's Guide to Compilation and Review Engagements*.

Notification of Users

The literature is vague about what should be done to ensure that the client has informed all financial statement users of a problem with previously issued financial statements. The authors believe the most practical solution is for the client to notify all users of their financial statements that they should no longer be relied upon and that revised statements will be issued. After consultation and agreement with the client, the CPA might directly contact each known user. If the CPA and the client do not agree on a course of action, the CPA should consider consulting legal counsel. After the financial statements have been revised, the accountant might also request a letter from the client indicating that all users have been notified and provided with copies of the revised financial statements and accountant's report. The steps that should be taken will depend upon the accountant's knowledge of persons who are currently using or who will use the financial statements and, if applicable, the accountant's report, and who would attach importance to the information, and the accountant's ability to communicate with them. Unless the accountant's attorney recommends a different course of action, the accountant ordinarily should take the following course of action:

a. Notify the client that the accountant's report should no longer be associated with the financial statements.

b. Notify regulatory agencies having jurisdiction over the client that the accountant's report should no longer be used.

c. Notify each person known to the accountant to be using the financial statements that the financial statements and the accountant's report should no longer be used.

Notification by the accountant to persons other than the client should include a description of the nature of the subsequently acquired information and its effect on the financial statements. The information included in the notification should be as precise and factual as possible and should not go beyond what is reasonably necessary. Comments concerning the conduct or motives of any person should be avoided.

SELF-STUDY QUIZ

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

10. Which of the following statements best describes an issue related to engagement letters?

    a. Engagement letters should always be addressed to those charged with governance.

    b. The SSARS require a new engagement letter for continuing engagements every year.

    c. The expected form and content of the accountant's report should be included in the engagement letter.

    d. SSARS engagement letters should be restricted to information about compilation or review engagements.

11. What is one advantage of mediation?

    a. Communication takes place through attorneys.

    b. A controlled atmosphere for the discussions.

    c. One party will win, and one will lose.

    d. Compromise is less important than a show of strength.

12. An entity's financial statements should be adjusted for subsequent events related to which of the following?

    a. Paying out on a product warranty from a reserve.

    b. The sale of a bond.

    c. The purchase of a business.

    d. A loss of inventory in a flood.

13. If facts are discovered subsequent to the date of an accountant's compilation or review report that indicate the report can no longer be relied upon, the accountant should typically do all of the following **except:**

    a. Notify the client that the report should no longer be associated with the financial statements.

    b. Notify the regulatory agencies having jurisdiction over the client that the accountant's report should no longer be used.

    c. Notify each person known to be using the financial statements that the accountant's report should no longer be used.

    d. Notify all parties known to be using the financial statements about the conduct or motives of the client in relation to the subsequently discovered facts.

SELF-STUDY ANSWERS

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

10. Which of the following statements best describes an issue related to engagement letters? **(Page 333)**

    a. Engagement letters should always be addressed to those charged with governance. [This answer is incorrect. Authoritative guidance states that the accountant should agree on the terms of the engagement with management or those charged with governance. Additionally, it says that, depending on the entity's structure, the engagement letter may be addressed to management, those charged with governance, or both. However, when the engagement letter is addressed only to those charged with governance, the accountant is still required to obtain management's agreement that it acknowledges and understands its responsibilities, as listed in AR-C 60.26b (AR-C 60A.26c). Therefore, this course recommends that engagement letters not be only addressed to those charged with governance.]

    b. The SSARS require a new engagement letter for continuing engagements every year. [This answer is incorrect. The SSARS do not specifically address whether the accountant's understanding with a continuing client needs to be documented in a new engagement every year. However, many accountants meet with their clients and update their engagement understandings at least annually. Therefore, this is a best practice, but it is not required by SSARS.]

    c. **The expected form and content of the accountant's report should be included in the engagement letter. [This answer is correct. The SSARS require the engagement letter to include the expected form and content of the accountant's report and a statement that there may be circumstances in which the actual report may differ from expectations.]**

    d. SSARS engagement letters should be restricted to information about compilation or review engagements. [This answer is incorrect. The SSARS say that they may be adapted for and applied to engagements related to other historical or prospective financial information. Specified elements, accounts, or items of a financial statement are listed as examples of other historical financial information to which SSARS may be applied.]

11. What is one advantage of mediation? **(Page 337)**

    a. Communication takes place through attorneys. [This answer is incorrect. With mediation, the parties are brought into the settlement discussions so they can hear first-hand (not through their attorneys) the strengths and weaknesses of their opponent's case.]

    b. **A controlled atmosphere for the discussions. [This answer is correct. Mediation frequently succeeds when direct bilateral negotiations between the parties fail. Mediation has certain advantages, including the fact that the discussion takes place in a controlled atmosphere. This prevents the parties from storming out of the discussions at the first sign of disagreement.]**

    c. One party will win, and one will lose. [This answer is incorrect. Mediation is not about winning or losing but rather about finding a resolution that is better than the result likely to be achieved through litigation. This is one of the advantages of this type of alternative dispute resolution (ADR).]

    d. Compromise is less important than a show of strength. [This answer is incorrect. One of the advantages of mediation is that, by communicating through the mediator, the parties are able to reach compromises that are not possible where neither party is willing to blink first for fear of showing weakness.]

12. An entity's financial statements should be adjusted for subsequent events related to which of the following? **(Page 341)**

    a. **Paying out on a product warranty from a reserve. [This answer is correct. According to FASB ASC 855-10, this is a type I subsequent event (a recognized subsequent event). This type consists of events that provide additional evidence about conditions that existed at the balance sheet date and that affect the estimates inherent in preparing financial statements. Subsequent events that affect the realization of assets (e.g., receivables and inventories) or the settlement of estimated liabilities (e.g., product warranty reserves) ordinarily should be adjusted for in the financial statements.]**

    b. The sale of a bond. [This answer is incorrect. The sale of a bond or capital stock issue is a type II subsequent event. As described in FASB ASC 855-10, type II subsequent events (nonrecognized subsequent events) are those that did not exist at the balance sheet date but arose after the balance sheet date but before the financial statements are issued or are available to be issued. Some nonrecognized subsequent events may require disclosure to keep the financial statements from being misleading, but the financial statements will not need to be adjusted.]

    c. The purchase of a business. [This answer is incorrect. The purchase of a business is a type II subsequent event, as discussed in FASB ASC 855-10. This type of subsequent event may need to be disclosed, but the financial statements do not need to be adjusted. If disclosure is required, the entity should disclose the nature of the event and an estimate of its financial effect, or a statement that such an estimate cannot be made.]

    d. A loss of inventory in a flood. [This answer is incorrect. The loss of plant or inventories caused by a natural disaster is considered a type II subsequent event, per FASB ASC 855-10. As such, it may require disclosure in the financial statements, but they would not need to be adjusted.]

13. If facts are discovered subsequent to the date of an accountant's compilation or review report that indicate the report can no longer be relied upon, the accountant should typically do all of the following **except: (Page 343)**

    a. Notify the client that the report should no longer be associated with the financial statements. [This answer is incorrect. Unless the accountant's attorney recommends a different course of action, the accountant normally should make this notification.]

    b. Notify the regulatory agencies having jurisdiction over the client that the accountant's report should no longer be used. [This answer is incorrect. The accountant should normally make this notification unless advised otherwise by an attorney.]

    c. Notify each person known to be using the financial statements that the accountant's report should no longer be used. [This answer is incorrect. Unless advised otherwise by an attorney, the accountant would typically notify such persons.]

    d. **Notify all parties known to be using the financial statements about the conduct or motives of the client in relation to the subsequently discovered facts. [This answer is correct. Notification by the accountant to persons other than the client should include a description of the nature of the subsequently acquired information and its effect on the financial statements. The information included in the notification should be as precise and factual as possible and should not go beyond what is reasonably necessary. Comments concerning the conduct or motives of any person should be *avoided*.]**

WORKPAPER DOCUMENTATION FOR REVIEWS, COMPILATIONS, AND OTHER ENGAGEMENTS

Required Workpapers for a Review Engagement

Workpaper documentation for review engagements is discussed in AR-C 90.137–.139 (AR-C 90A.94–.95). The accountant should prepare the documentation in sufficient detail to allow an experienced accountant, who is not a member of the engagement team, to understand—

a. The nature, timing, and extent of the procedures performed.

b. The results of the procedures performed and evidence obtained.

c. Significant findings or issues arising during the review, the conclusions reached, and judgments made in reaching those conclusions.

In addition, the review documentation should include the following—

a. Engagement letter.

b. Communications with management regarding fraud or noncompliance with laws and regulations.

c. Communications with management about the accountant's expectation to include an emphasis-of-matter or other-matter paragraph in the accountant's review report.

d. Communications with other accountants that have audited or reviewed the financial statements of significant components.

e. Justification for a departure from a relatively mandatory requirement and how the alternative procedure performed achieved the intent of the requirement, if applicable.

f. Representation letter.

g. Financial statements.

h. Accountant's review report.

The authors believe it is a best practice for the review workpapers to include only what is required by standards. It is risky from a litigation perspective to do otherwise. For example, accountants often include trial balances of entities that are rolled up into consolidated financial statements in their review workpapers. This is not required and should be avoided. Otherwise, a plaintiff is likely to erroneously assert that the analytical procedures and inquiries should have been applied not only to the reviewed financial statements but to the underlying trial balance details and consolidating information. Some of that detailed information may be problematic and perhaps even suggestive of error or fraud. Not only are accountants not ordinarily required to review such details, but those workpapers do not belong in the review workpaper documentation.

AR-C 90.41 (AR-C 90A.26) requires the accountant to obtain evidence that the financial statements agree to the accounting records. To obtain such evidence the accountant may compare the financial statements to the accounting records or supporting data in the client's records [AR-C 90.A70 (AR-C 90A.A48)]. Consequently, most practitioners choose to include a consolidated trial balance that shows agreement to the reviewed financial statements. However, the authors recommend not including the consolidating details.

SSARS No. 25, which is effective for engagements performed in accordance with the SSARS for periods ending on or after December 15, 2021, with early implementation allowed, requires the following additional items to be documented in a review engagement:

- Communications with management, those charged with governance, and others about significant matters, including their nature, that surface during the engagement (AR-C 90.138c).

- Information that is inconsistent with the accountant's findings about significant matters affecting the financial statements and how the inconsistencies were addressed (AR-C 90.138e).
- Who performed the review procedures and the date the procedures were completed (AR-C 90.139a).
- Who performed the technical review necessary to ensure engagement quality control, the extent of the review, and the date the review was performed (AR-C 90.139b).

SSARS No. 25 was discussed in Lesson 1.

Required Workpapers for a Compilation Engagement

Workpaper documentation for compilation engagements is discussed in AR-C 80.40 (AR-C 80A.40). The SSARS say the accountant should prepare documentation in sufficient detail to provide a clear understanding of the work performed. It does not, however, specify the form and content of the documentation but states that, at a minimum, the following should be included:

a. Engagement letter.
b. Justification for a departure from a relatively mandatory requirement and how the alternative procedure performed achieved the intent of the requirement, if applicable.
c. Financial statements.
d. Accountant's compilation report.

The list above is the minimum documentation required in the compilation standards. Including only those workpapers generally will not provide a clear understanding of all the work performed. Though outside the scope of this course, *PPC's Guide to Compilation and Review Engagements* provides a more extensive list of workpapers that have been identified, in the author's opinion, as *required* documentation when performing a compilation engagement.

The authors believe it is a best practice for accountants to avoid extraneous clutter in the compilation workpapers and only include the workpapers needed to provide a clear understanding of the work performed. To do otherwise may subject accountants to increased malpractice risks.

Required Workpapers for a Financial Statement Preparation Engagement

AR-C 70.22 (AR-C 70A.22) requires the accountant to prepare documentation in sufficient detail to provide a clear understanding of the work performed in connection with each preparation engagement. At a minimum, that documentation should include:

a. Engagement letter.
b. Financial statements.

Documentation Requirements for Nonattest Services

ET 1.295 of the Code requires accountants who perform nonattest services for their compilation or review clients to document in writing their understanding concerning those nonattest services with their client. The Code does not specify how the written understanding is to be documented, so the accountant has flexibility. For example, the understanding might be documented in a separate engagement letter, in the workpapers, in an internal memo, or in the engagement letter obtained in conjunction with the compilation or review. One option the accountant may choose is to document the understanding with the client about the performance of nonattest services, as well as other matters related to nonattest services, in a checklist such as the one provided in *PPC's Guide to Compilation and Review Engagements*. ET 1.295 and the Code are discussed later in this lesson.

Use of Checklists and Forms

Many CPAs will find that standard checklists and forms designed for their practices are useful in documenting compliance with the requirements of the SSARS and the quality control standards. Such checklists, of course, cannot be used blindly and are not substitutes for professional judgment. The use of a standard engagement letter was discussed earlier in this lesson.

Use of the Term *Partner*. The checklists and forms in *PPC's Guide to Compilation and Review Engagements* often use the term *partner* (for example, partner, engagement partner, or concurring partner) to indicate an individual holding a position of ownership. However, with the varied forms of legal entities in which CPA firms are permitted to practice, the term *partner* may not describe the position of ownership in some firms. For firms structured in legal forms other than partnerships (such as professional corporations and limited liability partnerships), this term should be viewed as interchangeable with *owner*, *shareholder*, *principal*, *director*, or *member*. Use of the term *partner* is not intended to imply that the firm is operating as a partnership.

Maintaining Engagement Documentation

Assembly of Engagement Documentation. QC 10.49 specifies that firms establish policies and procedures that require engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been released. Time limits for completing the assembly of final engagement files may be prescribed by professional standards, laws, or regulations. When no such time limits are prescribed, the firm is required to establish time limits that reflect the need to complete the assembly of final engagement files on a timely basis. Firms may adopt documentation completion periods either on an engagement-by-engagement basis, or as part of the firm's quality control policies and procedures.

Timely completion of engagement documentation is important to ensure engagement quality. As a practical matter, firms should strive to prepare engagement documentation as the engagement progresses to avoid inadvertently omitting critical information or incorrectly recording aspects of the procedures that were completed or the evidence obtained. Additionally, striving to assemble and maintain engagement documentation as the engagement progresses serves to make assembly of the engagement documentation more efficient.

Compilation and Review Documentation Assembly Requirements. The SSARS [AR-C 60.21diii (AR-C 60A.21diii)] specify that the engagement partner should take responsibility for ensuring that appropriate engagement documentation is maintained for all engagements performed under the SSARS. This requirement is included in a list of requirements directing the engagement partner to ensure that SSARS engagements are performed in accordance with the firm's quality control policies and procedures. Thus, the requirement is not specific or limited to only assembly of engagement documentation; it is broader, encompassing engagement documentation in totality.

Retention of Engagement Documentation. QC 10.51 states that firms should establish policies and procedures for the retention of engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations. QC 10.A61 adopts procedures that enable the preceding requirement to be met during the retention period and includes procedures, for example, that—

- Enable the retrieval of and access to engagement documentation during the retention period (particularly in the case of electronic documentation), as the underlying technology may need to be upgraded or revised over time.
- Where necessary, provide a record of changes made to engagement documentation after the assembly process is complete.
- Allow suitably qualified external individuals (those providing EQCR or consultation services, for example) and peer reviewers to easily access and review necessary engagement documentation.

Firms should also be aware that various states have enacted legislation or regulations that may require a stipulated retention period. In some cases, government agencies have specific record retention requirements that are made part of the contract for the specified engagement performance. Additionally, there may exist generally accepted retention periods in the absence of specific legal or regulatory requirements. Firms might consider consulting their attorneys and insurance carriers when establishing their retention policies.

Document retention policies should also recognize the need for exceptions in extenuating circumstances. Most notable, when engagement documentation is the subject of a subpoena, or contemplated or threatened subpoena or summons, no file or document destruction should occur until the related issues have been fully settled.

Compilation and Review Documentation Retention Requirements. SSARS does not address or establish requirements for the retention of workpapers. As is the case with document assembly, the engagement documentation retention requirements of QC 10 apply to accountants performing SSARS engagements. Not only should a firm develop procedures over the retention of compilation and review documentation, a firm should also include such policies and procedures in their QC system.

Retention Location. Accountants who perform compilation or review services for a client often perform other nonattest services, such as tax return preparation or bookkeeping services, or other attest services for the same client. In these instances, the question often arises regarding where the accountant who performs these multiple services for a client should file the workpapers. In other words, should all of the workpapers related to a client be filed together, should separate complete files be maintained for each type of service, or can the files for each type of service share some documents? Additionally, if a portion of the workpapers are electronic with the remaining portion being manual, how should the workpapers be filed?

The authors believe that neither the format or the location are relevant. It is only important that the accountant retain all of the required documentation and be able to locate this documentation when it is necessary (i.e., peer review, court order, use in subsequent years, etc.). Best practices would suggest that although accountants may maintain separate files for the engagements performed for an individual client, the accountant should store all of the engagement work related to an individual client together. In addition, best practices would also suggest that each manual workpaper related to a predominately electronic engagement should be listed in the electronic workpaper index as an external workpaper.

The authors suggest a written record retention policy be followed that includes an annual purge of files (whether electronic or paper). The policy should provide guidance applicable to the firm's practice considering laws, regulations, and state board rules. Issues such as carry forward basis issues for tax, estate return issues, gift tax issues, and other client service issues should also be addressed in a firm's policy. Care should also be taken to return client original records such as journal entries, depreciation schedules, basis calculations, etc., annually upon completion of each engagement so the client has a complete set of its accounting records to carry forward.

Confidentiality, Custody, Integrity, Accessibility, and Retrievability of Engagement Documentation. QC 10.50 indicates that firms should establish policies and procedures that are designed to provide for the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.

Confidentiality. The need to provide for a confidential relationship with a client is expressed in the *Confidential Client Information Rule* of the Code (ET 1.700.001.01), which states that members in public practice should not disclose any confidential client information without obtaining the client's specific consent. Ordinarily, engagement documentation can be shown outside of the firm only with the client's explicit permission. This is true even if a practitioner sells his or her practice to another firm, and it also applies to a predecessor communicating with a successor accountant. Specific laws or regulations may impose additional obligations on the firm to maintain client confidentiality, particularly when data of a personal nature are concerned.

ET 1.700.050 requires a CPA firm to ensure confidential client information is not disclosed when due diligence work is performed in connection with a potential purchase, sale, or merger of a CPA practice. Consequently, in these circumstances, firms will ordinarily obtain a written confidentiality agreement. In addition, CPA firms who obtain client files as the result of acquiring all or part of another CPA firm's practice should not disclose any confidential client information contained in those files

There are some limited exceptions to engagement documentation confidentiality. For example, explicit permission is not required for making engagement workpapers available if subpoenaed in connection with a court proceeding, if requested in an ethical disciplinary proceeding, or if submitted in an AICPA or state CPA society authorized quality or peer review program. Also, *Disclosing Client Information During Litigation* (ET 1.700.070.01) clarifies the firm's responsibility when providing confidential client information to the firm's professional liability insurance carrier; the

firm is not required to obtain a client's permission if the information is provided solely to assist in the defense against an actual or potential claim against the firm.

Custody, Integrity, Accessibility, and Retrievability. Engagement documentation may exist on paper, electronically, or in some other media. Regardless of how it exists, the integrity, accessibility, and retrievability of the underlying data may be compromised if the documentation could be altered, added to, or deleted without the firm's knowledge. Accordingly, controls are necessary to prevent engagement documentation from unauthorized use or alteration, or from becoming lost or damaged. The application and other explanatory material of QC 10.A56 indicates that, to avoid unauthorized alteration or loss, controls over engagement documentation may include controls that enable the firm to—

- Determine when and by whom engagement documentation was prepared and reviewed.
- Protect the integrity of information at all stages of the engagement, especially when information is shared within the engagement team or transmitted to other parties via electronic means.
- Prevent unauthorized changes to engagement documentation.
- Allow access to engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

Electronic Engagement Documentation. Many firms use paperless engagement software. As a result, the firm may scan engagement documents or otherwise convert original paper documentation to another media for inclusion in the engagement files. When that is the case, QC 10.A58 indicates that the firm's procedures may include requiring engagement team members to:

- Generate scanned copies that reflect a complete copy of the document (such as both sides of two-sided documents) and capture manual signatures, cross-references, and annotations.
- Integrate the scanned copies into the electronic engagement files, including indexing and signing off on the scanned copies as necessary.
- Enable the scanned copies to be retrieved and printed as needed.

Even firms that have completely achieved the *paperless office* concept for their engagements may have legal, regulatory, or other reasons to retain some original paper documentation. Accordingly, those firms should ensure that their QC policies and procedures over engagement documentation confidentiality, safe custody, integrity, accessibility, and retrievability encompass hard copy documents as well.

Additional controls that firms might design and implement to maintain the safe custody, integrity, accessibility, and retrievability of engagement documentation may include controls such as the following:

- The use of data encryption and passwords by engagement team members to restrict access to electronic engagement documentation to authorized users.
- Back-up routines for electronic engagement documentation at appropriate stages during the engagement.
- Procedures for distributing engagement documentation to the team members at the beginning of the engagement, processing it during the engagement, and collating it at the end of the engagement.
- Procedures to restrict access to, and enable proper distribution and confidential storage of, hard copy engagement documentation.

Another item for consideration should be email and other forms of electronic communications among the team members and client personnel. This is a significant litigation risk in a compilation and review practice. Those communications have to be produced in discovery during legal proceedings. Furthermore, they cannot be destroyed in anticipation of litigation. They nearly always hurt the CPA firm's defense and rarely help it. Why? Because the communications frequently raise questions about incomplete information, or even questionable information, without any documentation of how those matters were resolved in additional emails or in the workpapers. The authors recommend limiting electronic communications and destroying any of those communications that are not part of the

engagement documentation when the engagement is archived. In addition, the authors recommend having periodic training for professional staff on email protocol and the risks related to "thinking with other engagement team members through email."

COMMUNICATIONS THAT MAY TAKE PLACE BETWEEN PREDECESSOR AND SUCCESSOR ACCOUNTANTS

A successor accountant is *not* required to communicate with a predecessor in connection with a compilation or review engagement. (Note: AU-C 510 requires communication between successor and predecessor *auditors*.) However, a successor accountant *may* decide to communicate with the predecessor. The AICPA Guide addresses communications when prior-period financial statements require revision. The SSARS do not include guidance concerning communications between predecessor and successor accountants. However, if the successor wishes to make inquiries of the predecessor and the client refuses, the accountant should consider the reasons for the refusal and its implications on accepting the engagement. The refusal itself does not preclude an accountant from accepting the engagement; however, the refusal may cause doubt about management's integrity or management's reliability in making available all relevant resources and information. According to AR-C 60.25 (AR-C 60A.25), those doubts, in addition to doubt about relevant ethical requirements (such as independence requirements) being able to be satisfied, provide a reasonable basis for not accepting a SSARS engagement.

Communications in Connection with Acceptance of an Engagement

The authors believe communication between predecessor and successor accountants in connection with the acceptance of an engagement may be desirable when—

a. Information about the prospective client is limited or requires special attention.

b. The change in accountants occurs substantially after the end of the accounting period for which financial statements are to be compiled or reviewed.

c. The client has frequently changed accountants.

If the successor elects to communicate, orally or in writing, with the predecessor, inquiries such as the following might be made:

a. Does the client have integrity?

b. Has the predecessor had disagreements with the client about accounting matters or the performance of compilation or review procedures?

c. Has the client cooperated when additional or revised information was needed?

d. Does the predecessor have any knowledge of any fraud or noncompliance with laws and regulations perpetrated within the client?

e. Why has the client switched accountants?

The predecessor should respond fully to the successor's request for information. If, however, due to unusual circumstances (which include such things as impending, threatened, or potential litigation or disciplinary proceedings, but do not include unpaid fees), the predecessor decides not to respond fully, he should indicate that his response is limited. If this happens, the successor should consider whether he can accept the engagement.

The successor may wish to obtain access to the predecessor's workpapers. Ordinarily, workpapers relating to matters of continuing accounting significance and those relating to contingencies should be made available by the predecessor. However, valid business reasons (e.g., unpaid fees) may lead the predecessor to decide not to allow access to his workpapers. (Caveat: Ethics rulings prohibit a predecessor accountant from withholding books and records belonging to the client regardless of any unpaid fees.) If the successor uses the predecessor's workpapers, no reference to the predecessor accountant should be made in the compilation or review report except as specifically permitted with respect to comparative financial statements.

As required by the Code, a successor accountant should obtain the client's permission if he decides to make inquiries of the predecessor, and the client should authorize the predecessor to respond fully. If the client will not permit communication, the successor should consider withdrawing from or not accepting the engagement. The successor accountant may make inquiries before making a proposal for the engagement. In addition, before permitting access to the working papers, the predecessor accountant may wish to obtain a written communication from the successor accountant regarding the use of the working papers.

Communications When Successor Believes Prior-period Financial Statements Require Revision

When, during the course of his compilation or review engagement, the successor accountant becomes aware of information that leads him to believe the prior-period financial statements reported on by the predecessor accountant require revision, a successor accountant may request that the client communicate that information to the predecessor accountant. If the client refuses or if the successor is not satisfied with the course of action taken by the predecessor, the authors believe the successor accountant should evaluate the possible implications for the current engagement and consider whether to resign from the engagement. In addition, the successor accountant may wish to consult with his attorney.

Though outside the scope of this course, more guidance about what to do in this situation is available in *PPC's Guide to Compilation and Review Engagements*.

PRACTICE ISSUES THAT MAY OCCUR WHEN PERFORMING COMPILATION AND REVIEW ENGAGEMENTS

Practicing a profession is generally a stimulating and intellectually rewarding undertaking; however, practice issues and the threat of legal liability can cast shadows on professional lives and ruin an otherwise successful professional career. This section addresses several practice issues that accountants should consider while performing compilation and review engagements.

Litigation Risks

Although there is a lack of published cases on financial statement preparation, compilation, and review engagements, liability insurance claims against CPA firms strike at a rate of one claim per year for approximately every 120 professionals. Claims arising from compilation engagements alone compose 6% of all malpractice claims filed each year. CPA firms that do only tax, financial statement preparation, compilation, and review work should never assume that their malpractice risk is immaterial, as it is not unusual for small CPA firms with no audit practice to be hit with claims seeking in excess of $1 million. Because of the potentially disastrous effects of liability claims, every CPA firm needs to develop systems designed to avoid liability claims and to minimize their impact. Defensive measures CPA firms should use include—

- Quality control (which covers compilation and review engagements),
- Professional liability insurance,
- Other protective measures, and
- Engagement letters (which are required in all financial statement preparation, compilation, and review engagements).

Quality Control. QC 10 establishes standards and provides guidance for a CPA firm's system of quality control responsibilities for its accounting and auditing practice. QC 10 requires the firm to establish a system of quality control designed to provide reasonable assurance that the firm complies with professional standards and issues reports appropriate in the circumstances. The standard also requires the firm to document and communicate its quality control policies and procedures. QC 10 is discussed in more detail later in this lesson.

Traditionally, CPA firms have tried to employ quality control systems as their first line of defense on the assumption that a firm that practices according to the dictates of the profession makes itself invulnerable to liability claims. While following quality control measures clearly decreases the possibility of substandard performance, it is by no means a

perfect defense against claims. In order to maximize compliance with applicable professional standards and minimize risks of substandard performance, every CPA firm should develop a quality control system as discussed later in this lesson.

Professional standards are not the "end all" for CPAs. Many CPAs believe they are protected from liability lawsuits because they followed the rules. They also think that conformity with professional standards provides a safe harbor against liability. Unfortunately, that is often not the case when defending a liability claim. Professional standards are vitally important, but complying with professional standards may not be sufficient to avoid liability. CPAs are expected not only to follow standards, but to get it right. While other defenses are available to CPAs, the failure to follow a CPA's internal quality control standards becomes a significant obstacle to overcome in avoiding legal liability. Therefore, it is essential that the CPA firm design a quality control system that simultaneously satisfies professional standards and is practical and appropriate for the size and type of firm.

Professional Liability Insurance. CPA firms rely on professional liability insurance to pay the liabilities and costs of defending against claims. While liability insurance is essential for all professional firms, it is only one resource for protection of a professional's assets and not a means to prevent liability. At the same time, all professional liability insurers impose their own standards of quality control and implementation of quality control measures on their insured professionals.

It is not clear that every insurer will provide coverage for all claims that may arise out of the wide variety of services that are now being offered by CPA firms. This is especially true of claims based on erroneous investment advice or intentional misconduct, as many insurers remain unwilling to cover such claims. Insurance generally does not protect against liability awards based on fraud by the CPA. Firms should inquire of their insurers whether the insurance will cover the costs of defense against government investigations where there are no private litigants involved. Before undertaking a new type of service (e.g., cannabis industry), a professional firm should explore with its insurer whether such services are included within the definition of covered professional services.

Equally important, it is virtually impossible for accounting firms to purchase enough insurance to cover the largest claims that may be asserted against them. Even if such insurance were available, it would likely be too costly for an accounting firm to purchase on an annual basis. Thus, even those firms that do purchase professional liability insurance are likely to face the possibility that such insurance may not cover the full extent of the claims that may be asserted against them. Firms need to consider the nature of the practice in determining insurance coverage levels.

Firms should also consider purchasing employment practices liability insurance to cover the firm against allegations such as discrimination or harassment and cyber security insurance to cover the firm against claims arising out of data breaches.

Other Protective Measures. Because of the limitations in professional liability insurance and the inability of some CPA firms to purchase insurance with sufficient policy limits to cover their full risk exposure, a CPA firm must turn to the following protective measures to minimize the impact of any claims or potential claims against the firm:

- Risk avoidance.
- Firm structure.
- Damage control.

Risk Avoidance. Risk avoidance includes a variety of loss prevention techniques that focus on—

- Limiting the types of clients and engagements the firm accepts.
- Staying within the scope of the engagement.
- Applying professional skepticism throughout the engagement.

Gone are the days when CPA firms made client acceptance decisions solely on the basis of whether the engagement could be performed profitably. Today, before accepting an engagement, CPA firms should not only examine the economics of servicing the client but also the potential liability risks posed by the engagement. (QC 10 requires firms to establish policies and procedures for client and engagement acceptance and continuance.)

CPAs ought to stay within the scope of the engagement and only perform the services they have been hired to perform. All services ought to be included in the engagement letter. (Engagement letters were discussed earlier in this lesson.) If the scope of the services to be performed after the CPA has initially been engaged changes, a new engagement letter, or amendment to the existing engagement letter, ought to be issued. For example, if the CPA is hired to prepare a tax return and prepares the financial statements as a by-product of the tax return, the CPA ought to consider including the financial statement preparation in the engagement letter if the CPA plans to give the financial statements to the client.

Applying professional skepticism throughout the engagement will help mitigate risks. Consider potential risk factors. Do not become complacent and comfortable with long time clients. Be objective and follow-up on matters that do not seem right.

Firm Structure. Another protective measure is to insulate the assets of the firm and its owners in the event that the firm's defenses against liability prove ineffective and either liability insurance is not available for such claims or the policy limits are exceeded. Subject to state laws and regulations affecting professional organizations, a firm should be organized as a legal entity (professional corporation, limited liability partnership, or limited liability company) which, to a degree, insulates its owners from the liabilities of the firm. It should be noted that most state statutes will continue to hold the individual owner who breaches professional obligations responsible for his or her own actions and the actions of the persons he or she supervises. If any claim against the firm is successful, the liability is satisfied first out of a firm's professional liability insurance and then out of the firm's assets. Notwithstanding the foregoing, the firm and its owners will continue to be responsible for the retention amounts associated with the firm's liability policy.

In addition to these structural protections, CPAs can protect their personal assets in a number of other ways, including placing assets in protected pension plans and holding property jointly with others with rights to survivorship. Moreover, personal assets may be protected by personal liability insurance, outright transfers of assets to others, or assets placed in a trust.

Damage Control. An essential protective measure is the establishment of an internal procedure for managing any claims threatened or actually asserted against the professional. Damage control procedures focus on responding quickly to threatened and actual liability claims and designating a response team to manage the internal process. Often the manner in which a firm handles internal communications and communications with counsel when a claim is first threatened or asserted may have an impact on the ultimate resolution of such a claim.

Engagement Letters. Finally, as previously discussed, the SSARS require practitioners to always utilize an engagement letter when performing preparation, compilation, and review engagements. The form and content of the letters should be structured to help minimize legal liability.

Responsibility for Fraud and Noncompliance with Laws and Regulations

The SSARS set forth the accountant's responsibilities for fraud and noncompliance with laws and regulations in compilation and review engagements. The SSARS defines *fraud* as an intentional act that causes a misstatement in the financial statements and defines *noncompliance* as intentional or unintentional violations of laws or government regulations, excluding fraud.

Do AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, and AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, apply to compilation and review engagements? The answer is no. AU-C 240 and AU-C 250 apply only to audits of financial statements conducted in accordance with generally accepted auditing standards. SSARS performance standards do not require accountants to document their assessment of fraud in a compilation or review engagement. Nor do SSARS performance requirements impose detection requirements for noncompliance with laws and regulations. However, in a review engagement, the accountant is required to obtain limited assurance about whether the financial statements are free of material misstatement, whether caused by error, fraud, or noncompliance with laws and regulations. AR-C 90 (AR-C 90A) states that when conducting a review of financial statements, the accountant should inquire of members of management who have financial and accounting responsibilities concerning their knowledge of any fraud or suspected fraud that could have a material impact on the financial statements. The inquiry and analytical procedures performed in a review should provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the financial statements. No expression of assurance is

contemplated in a compilation. In addition, the SSARS obligate the accountant in both compilation [AR-C 80.14 (AR-C 80A.14)] and review [AR-C 90.45 (AR-C 90A.29)] engagements to obtain additional or revised information when the accountant becomes aware of information that is incorrect, incomplete, or otherwise unsatisfactory.

Use of Engagement Letters to Clarify the Accountant's Responsibilities. Management is responsible for the prevention and detection of fraud and noncompliance with laws and regulations, and the maintenance of internal control. However, many small business clients do not understand management's responsibility. They may have unrealistic expectations and may assume that the accountant is providing a higher level of assurance than he or she actually is, including detecting fraud, noncompliance with laws and regulations, and internal control deficiencies. A written engagement letter is required by AR-C 70.10 (AR-C 70A.10), AR-C 80.10 (AR-C 80A.10), and AR-C 90.11 (AR-C 90A.11) and can be helpful in clarifying and documenting the understanding of the accountant's responsibility regarding fraud, noncompliance with laws and regulations, and internal control deficiencies. This written understanding should provide, among other things, that the engagement cannot be relied upon to disclose errors, fraud, or noncompliance with laws and regulations.

Whether an act actually is fraudulent or a violation of laws and regulations is a determination that is normally beyond the accountant's professional competence. Accountants—when reporting on financial statements—present themselves as being proficient in accounting and compilation and review services. The accountant's training, experience, and understanding of the client and its industry may cause him or her to recognize some client acts as fraudulent or a violation of laws and regulations. However, the determination of whether a particular act is fraudulent or a violation of laws and regulations should be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law.

Client Representation Letters in Review Engagements. In addition, AR-C 90.60 (AR-C 90A.34) requires the accountant to obtain written representations, including the following fraud-related representations, for all financial statements and periods covered by the accountant's review report:

- Management's acknowledgment of its responsibility to prevent and detect fraud.
- Knowledge of any fraud or suspected fraud that could have a material effect on the financial statements, such as communications about fraud received from employees, former employees, or others.

These representations help clarify and document management's understanding of its responsibilities regarding fraud.

Communication of Suspected Fraud or Noncompliance with Laws and Regulations. AR-C 90.34–.36 (AR-C 90A.51) addresses the question of what the accountant should do to communicate suspected fraud or noncompliance with laws and regulations discovered during the performance of a review engagement. When the accountant suspects fraud or noncompliance with laws and regulations may have occurred, the matter should be communicated to the appropriate level of management. The accountant is required to report all suspected fraud; however, the accountant need not report matters regarding noncompliance with laws and regulations that are clearly inconsequential (e.g., misdemeanor traffic violation) and may reach agreement in advance with the entity on the nature of any such matters to be communicated. The authors suggest reporting *all* suspected fraud and noncompliance with laws and regulations. If the suspected fraud or noncompliance with laws and regulations involve senior management, then the matter should be communicated at the highest level within the company. And, if the suspected fraud or noncompliance with laws and regulations involves the owner of the company, the accountant should consider resigning from the engagement and consulting legal counsel. Additional procedures are not required to substantiate whether fraud or noncompliance with laws and regulations have, in fact, occurred. However, the accountant should request that management consider the effect of the matter on the financial statements. In addition, the accountant should consider the impact the suspected matters might have on the engagement. The accountant is required to document any communications, whether oral or written, regarding fraud or noncompliance with laws and regulations. AR-C 80 (AR-C 80A) does not address communications about fraud and noncompliance with laws and regulations and, therefore, does not have a requirement to communicate or document any communication. However, the authors believe it is best practice to do so.

The disclosure of any evidence or information that comes to the accountant's attention during the performance of the compilation or review procedures that indicate fraud or noncompliance with laws and regulations may have occurred

to third parties is not usually the accountant's responsibility. In fact, in most instances, the accountant is precluded from communicating such matters to third parties by ethical and legal obligations of confidentiality. There are certain instances, however, such as complying with legal and regulatory requirements, communicating with a successor accountant regarding acceptance of an engagement, and responding to a subpoena, where an accountant has a duty to disclose matters related to fraud and noncompliance with laws and regulations to parties outside of the entity.

Other Practice Issues

Bookkeeping Services. Accountants who perform SSARS engagements for their clients often also perform bookkeeping services for those same clients. Bookkeeping engagements have usually been viewed as presenting minimal professional liability risk because the accountant provides no assurance and the work is relatively straightforward and without technical complexities. However, if a client company suffers a financial loss due to fraud or theft, the accountant is often viewed by the client as contributing to the loss. Consequently, there is a growing trend of lawsuits being filed against accountants who perform bookkeeping services when the accountant fails to detect fraud or theft.

The potential for fraud exists on all engagements. The accountant's responsibility to detect fraud is often different than the public's perception of the accountant's responsibility. See the discussion of the accountant's responsibility for fraud in SSARS engagements provided earlier in this section. When performing bookkeeping services, the authors believe that the accountant should take special care in having an engagement letter that specifically details exactly what procedures the accountant will perform. This is especially important as it relates to any work being performed relative to the cash account. For example, if the accountant is performing a bank reconciliation, the engagement letter should specify exactly what procedures will (or will not) be performed with respect to the payee and endorsement of the cancelled checks. That is, the engagement letter should clearly communicate whether the accountant will look at cancelled checks to review for proper payees or endorsements.

Licensing Problems. State legislatures and the courts have determined that it is in the public interest to regulate professional services offered by CPAs. Accountancy laws governing the licensing of certified public accountants and prescribing entry requirements for those who wish to hold themselves out to the public to practice accounting have been enacted in all fifty states, District of Columbia, Puerto Rico, Guam, and Virgin Islands.

CPAs should also consider applicable state board of accountancy licensing and registration requirements for the firm and its personnel. Most states require firms to possess a firm (also known as a practice unit) license. Accordingly, sole practitioners are ordinarily required to possess two licenses: a firm license and an individual license to practice as a CPA. In all other firms, in addition to the one firm license, each professional in the firm who has passed the Uniform CPA Exam and has met the experience requirement of their state board is also required (in most states) to possess an individual CPA license. During a peer review, a firm will be asked to provide written representation that the firm is in compliance with all licensing requirements and that firm members are in compliance with individual licensing requirements. In addition, a reviewer is required to verify the firm's practice unit license in the state the firm is domiciled and, for a sample of personnel, individual licenses in the state in which the individual primarily practices public accounting. Verification is met by the firm providing documentation from the licensing authority that the license is appropriate and active during the peer review year, and through the earlier of the reviewed engagements' issuance dates or the date of peer review fieldwork. A firm may also do business in states other than where it is domiciled. Those states may also require licenses. In addition, if a CPA is acting as an expert witness in a state in which he or she is not licensed, his or her testimony may be disallowed. Many other issues also arise due to improper licensing. Although many state requirements are similar to those of the AICPA, they do vary from state to state. Because the licensing rules may vary from state to state, the CPA firm should investigate a state's licensing requirements by contacting the applicable state board or consulting an attorney prior to doing business in that state.

Commissions, Referral Fees, and Contingent Fees. ET 1.520.001.01 of the Code prohibits members from accepting commissions and referral fees from clients for whom the member performs the following:

a. Examinations of prospective financial information.

b. Audits of financial statements.

c. Reviews of financial statements.

d. Compilations of financial statements, unless the report discloses a lack of independence.

ET 1.510.001.01 of the Code prohibits a member from accepting contingent fees from a client for whom he performs any of the services described in the previous paragraph. In addition, it prohibits a member from accepting contingent fees for preparing an original or amended tax return or a claim for refund. There are certain exceptions to the prohibition of contingent fees as noted in ET 1.510.001.03.

When deciding whether to accept commissions, referral fees, and contingent fees, practitioners also should consider the rules and regulations of the states in which they practice. Many states have specific laws governing the acceptance of commissions, referral fees, and contingent fees, some of which may differ from the AICPA's rules.

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 types of documentation should be included in the workpapers for a review but not in the workpapers for a compilation?

    a. An engagement letter.

    b. A compilation report.

    c. Communications with management about fraud.

    d. Trial balances of entities that are included in consolidated financial statements.

15. When might an accountant want to communicate with a predecessor auditor before accepting a compilation or review engagement?

    a. The prospective client provides more information than requested, and it is difficult to sift through.

    b. The change in accountants occurs prior to the end of the accounting period for the SSARS engagement.

    c. The client has changed accountants frequently in the past few years.

    d. The accountant is required to make such a communication based on information in the SSARS.

16. What is a CPA firm's first line of defense against the risk of liability claims?

    a. Damage control.

    b. Engagement letters.

    c. Professional liability insurance.

    d. Quality control.

SELF-STUDY ANSWERS

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

14. Which of the following types of documentation should be included in the workpapers for a review but not in the workpapers for a compilation? **(Page 348** and **Page 349)**

    a. An engagement letter. [This answer is incorrect. Engagement letters would be included in the workpapers for both a compilation and a review.]

    b. A compilation report. [This answer is incorrect. A compilation report would be included in the workpapers for a compilation engagement. A review report would be included in the workpapers for a review engagement.]

    c. **Communications with management about fraud. [This answer is correct. Several types of communications are included in the workpapers for a review engagement that are not included in the workpapers for a compilation. Those include (1) communications with management regarding fraud or noncompliance with laws and regulations, (2) communications with management about the accountant's expectation to include an emphasis-of-matter or other-matter paragraph in the review report, and (3) communications with other accountants that have audited or reviewed the financial statements of significant components.]**

    d. Trial balances of entities that are included in consolidated financial statements. [This answer is incorrect. This course suggests that it is a best practice for review workpapers to include only the items that are required by the standards. It is risky from a litigation perspective to do otherwise. For example, accountants often include trial balances of entities that are rolled up into consolidated financial statements in their review workpapers. This is not required and should be avoided. Otherwise, a plaintiff is likely to erroneously assert that the analytical procedures and inquiries should have been applied not only to the reviewed financial statements but to the underlying trial balance details and consolidating information.]

15. When might an accountant want to communicate with a predecessor auditor before accepting a compilation or review engagement? **(Page 353)**

    a. The prospective client provides more information than requested, and it is difficult to sift through. [This answer is incorrect. As suggested in this course, communication with a predecessor accountant before accepting an engagement may be desirable when information about the prospective client is limited or requires special attention. That communication is less likely to be needed if the successor has plenty of information.]

    b. The change in accountants occurs prior to the end of the accounting period for the SSARS engagement. [This answer is incorrect. Such communication is more likely to be desirable when the change in accountants occurs substantially *after* the end of the accounting period for which financial statements are to be compiled or reviewed.]

    c. **The client has changed accountants frequently in the past few years. [This answer is correct. Though not required by the SSARS, this course suggests several instances in which communication between predecessor and successor accountants in connection with the acceptance of an engagement may be desirable. One such instance is when the client has frequently changed accountants.]**

    d. The accountant is required to make such a communication based on information in the SSARS. [This answer is incorrect. A successor accountant is *not* required to communicate with a predecessor in connection with a compilation or review engagement. However, a successor accountant *may* decide to communicate with the predecessor.]

16. What is a CPA firm's first line of defense against the risk of liability claims? **(Page 354)**

    a. Damage control. [This answer is incorrect. An essential protective measure is the establishment of internal procedures for managing any claims threatened or actually asserted against the professional. Damage control procedures focus on responding quickly to threatened and actual liability claims and designating a response team to manage the internal process. However, these procedures do not come into play until the claim is at least threatened; therefore, there are defensive measures that can be taken prior to the need for damage control.]

    b. Engagement letters. [This answer is incorrect. The SSARS require practitioners to always utilize an engagement letter when performing preparation, compilation, and review engagements. The form and content of the letters should be structured to help minimize legal liability. However, there are things a firm can have in place prior to accepting an engagement and providing an engagement letter that can help the firm defend itself against legal liability.]

    c. Professional liability insurance. [This answer is incorrect. CPA firms rely on professional liability insurance to pay the liabilities and costs of defending against claims. While liability insurance is essential for all professional firms, it is only one resource for the protection of a professional's assets and not a means to prevent liability. Also, the insurance comes into play once claims already exist and are costing the firm money; therefore, there is an earlier line of defense that can be taken prior to the need for insurance.]

    d. **Quality control. [This answer is correct. Traditionally, CPA firms have tried to employ quality control systems as their first line of defense against litigation risks and the potentially disastrous effects of liability claims on the assumption that a firm that practices according to the dictates of the profession makes itself invulnerable to liability claims. However, while following quality control measures clearly decreases the possibility of substandard performance, it is by no means a perfect defense against claims. CPAs are expected not only to follow the standards but to get it right. It is essential that the CPA firm design a quality control system that simultaneously satisfies professional standards and is practical and appropriate for the size and type of firm. Therefore, while the quality control system may be the first line of defense, other measures should be taken to help defend the firm.]**

QUALITY CONTROL, PEER REVIEW, AND ETHICS STANDARDS THAT APPLY TO COMPILATION AND REVIEW ENGAGEMENTS

The AICPA and the state societies of CPAs attempt to maintain self-regulation of firm quality and professionalism through various committees, such as ethics committees and practice review committees. The Public Company Accounting Oversight Board (PCAOB) has the authority to establish auditing, quality control, ethics, independence, and other standards relating to audits and to conduct quality reviews of accounting firms that have issuer clients.

The AICPA's Quality Control Standards, Peer Review Program, and *Code of Professional Conduct*, are discussed in the following paragraphs. This section is intended to provide a high-level overview of the AICPA's quality control and peer review standards. *PPC's Guide to Quality Control—Compilation and Review* discusses quality control and peer review in more detail.

Quality Control Standards

QC 10 establishes standards and provides guidance for a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. The purpose of a quality control system is to promote quality in performing accounting and auditing engagements. A firm's system of quality control is a system designed to provide the firm with reasonable assurance that (a) the firm and its personnel are complying with professional standards and legal and regulatory requirements, and (b) that reports issued by the firm are appropriate in the circumstances. In developing and maintaining its quality control system, a firm establishes policies designed to achieve the objectives associated with obtaining reasonable assurance and procedures required to implement and monitor compliance with those policies. In the context of QC 10, *reasonable assurance* is a high level of assurance, but not absolute assurance.

The firm's quality control system should consist of policies and procedures. The nature of the policies and procedures the firm develops to obtain reasonable assurance and comply with the requirements of QC 10 will depend on various factors, such as the following:

- The size of the firm.
- The operating characteristics of the firm, for example—
  - Types of services provided.
  - Types of industries served.
  - Number of partners.
  - Number of professional personnel.

Professional Requirements. QC 10.08 establishes requirements regarding the firm's degree of responsibility it has in complying with the requirements of the standard. The firm's professional requirements as defined in the standard are designated into two categories:

- *Unconditional Requirements.* Unconditional requirements are those the firm must follow in all cases if the circumstances apply to the requirement. These requirements use the word *must*.
- *Presumptively Mandatory Requirements.* Firms are also expected to comply with presumptively mandatory requirements if the circumstances apply to the requirement; however, in rare situations, a departure from the requirement is allowed if the firm documents the justification and how alternative procedures that were performed were sufficient to achieve the objectives of the requirement. Presumptively mandatory requirements are identified by the word *should*. If the standard uses the words *should consider* for a procedure, the consideration of the procedure is presumptively required.

Elements of a Quality Control System. QC 10.17 states that the firm's system of quality control should incorporate policies and procedures that address each of the following QC elements:

- *Leadership Responsibilities for Quality Within the Firm (or Tone at the Top).* The firm has policies and procedures to promote an internal culture recognizing that quality is essential in performing engagements.
- *Relevant Ethical Requirements.* The firm and its personnel comply with relevant ethical requirements.
- *Acceptance and Continuance of Client Relationships and Specific Engagements.* The firm undertakes or continues only client relationships and engagements in which the firm (a) considers the client's integrity and does not have information that would indicate the client lacks integrity; (b) determines the firm has the competence, capabilities, and resources to perform the engagement; and (c) determines the firm can comply with legal and regulatory requirements.
- *Human Resources.* The firm has sufficient personnel with the competence, capabilities, and commitment to ethical principles to (a) perform engagements in accordance with professional standards and applicable legal and regulatory requirements and (b) enable the firm to issue reports that are appropriate in the circumstances.
- *Engagement Performance.* Work performed by engagement personnel consistently complies with applicable professional standards and regulatory requirements, and the firm issues reports that are appropriate in the circumstances.
- *Monitoring.* The policies and procedures established by the firm for the other elements of quality control are relevant, adequate, and operating effectively.

Relationship of SSARS to Quality Control Standards. Statements on Quality Control Standards relate to the conduct of a firm's entire accounting practice. The SSARS relate to the conduct on individual preparation, compilation, and review engagements. The quality control policies and procedures that a firm adopts could affect the conduct of an individual engagement and affect the firm's overall accounting practice. However, deficiencies or instances of noncompliance with a firm's quality control policies and procedures do not necessarily indicate that an engagement was not performed in accordance with professional standards or that the accountant's report, if applicable, was not appropriate [AR-C 60.A43 (AR-C 60A.A42)].

Documentation and Communication of the Firm's QC Policies and Procedures. QC 10.18 requires that the firm document its QC policies and procedures. Matters such as the nature of the firm's practice, its size, and its structure may be considered in determining the *extent* of documentation of the firm's QC policies and procedures. Documentation of the policies and procedures of a single-office firm with a small number of partners and staff might not be expected to be as extensive as those of a large, multi-office firm.

QC 10 does not require the firm to have a formal quality control policies and procedures *document*; instead, the standard indicates only that the firm's QC policies and procedures be *documented*. Thus the QC standard allows the firm to have flexibility and latitude in determining the documentation method that best suits their individual practice and circumstances.

In addition to documenting the firm's QC policies and procedures, QC 10.18 indicates that the firm should communicate its QC policies and procedures to firm personnel. That communication is not required to be in writing, although written communication is preferable. An effective firm communication of its QC policies and procedures, as described in QC 10.A2, generally incorporates the following:

- A description of the policies and procedures and the objectives they achieve.
- A message that each person is responsible for maintaining quality, as well as being familiar with the policies and procedures and complying with them.
- Comments stressing the importance of receiving feedback on how the QC system is operating and encouraging staff to communicate their concerns on quality control issues.

The documentation and communication requirement is applicable to firms that have a compilation and review practice, as well as firms that have an accounting and auditing practice, and requires those firms to undergo a peer review at least once every three years. As a result, such firms should have in place a quality control system that will withstand such a review or risk termination of firm membership in the program, individual memberships in the AICPA, and loss of their state licenses to practice.

Quality control materials (QCM) provide guidance to assist firms in performing and reporting in conformity with professional standards and may include, but are not limited to, engagement aids (including accounting and auditing nonauthoritative guidance), checklists, questionnaires, work programs, electronic accounting and auditing tools, and similar materials designed to be used by accounting and auditing engagement teams. When designing the firm's quality control policies and procedures, the firm should indicate the QCM that are being used, or make reference to the firm's accounting materials that contain the firm's QCM.

In conjunction with its *Enhancing Audit Quality* initiative, the AICPA developed and released e-versions of its previously published Practice Aid, *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (the AICPA Practice Aid). The information is currently available at no charge on the AICPA's website at **www.aicpa.org/InterestAreas/frc/pages/EnhancingAuditQualityPracticeAid.aspx**. The redeveloped AICPA Practice Aid provides illustrative examples of various types of policies and procedures a firm may consider when developing its system of quality control under the guidelines of QC 10. Illustrative examples of quality control documents are provided for two hypothetical firms:

- Small- and medium-sized firms.
- Sole practitioners.

The redeveloped AICPA Practice Aid is the joint effort of the Peer Review Board and the ASB, and while not authoritative, it may be a beneficial resource for use by firms when drafting QC policies and procedures. The redeveloped AICPA Practice Aid includes tips, warnings, and reminders to help firms implement their QC policies and procedures.

In addition, *PPC's Guide to Quality Control—Compilation and Review* can assist firms in this task. It illustrates suggested policies and procedures that address the elements of quality control listed in QC 10. It is integrated with the checklists and procedures that are presented in *PPC's Guide to Compilation and Review Engagements* and is updated annually to keep firms aware of recent developments relating to quality control issues and peer reviews. The authors encourage practitioners to add *PPC's Guide to Quality Control—Compilation and Review* to their libraries. [For order information call (800) 431-9025 or access PPC's website at **tax.thomsonreuters.com**.]

Establishing Criteria for Engagement Quality Control Reviews (EQCR). Firms are required to establish criteria as part of their QC policies and procedures for determining when an EQCR should be performed. In establishing criteria for performance of an EQCR, the structure and nature of the firm's practice are important. QC 10.A41 indicates that such criteria may include considerations such as the following:

- The nature of the engagement, including whether it involves a matter of public interest.
- Whether unusual circumstances or risks have been identified relating to the engagement, engagement service type, or industry.
- Whether laws or regulations require an engagement quality control review to be performed.

If no engagements meet the criteria established by the firm for review, no EQCRs are required to be performed.

As mentioned earlier in this lesson, COVID-19 has significantly altered the business operations of many entities and increased the level of risk on those engagements. As such, the authors believe that some firms may consider adding COVID-19 engagement risk considerations to their criteria for performing EQCR, especially when impairment or going concern are an issue on a particular engagement.

The structure and nature of the firm's practice are important factors in establishing criteria to consider when determining which engagements are to be subject to an EQCR. Accordingly, the authors recommend that firm

management begin the process of developing EQCR policies and procedures by considering the firm's unique structure and nature. Firm structure includes the size of the firm, the number of partners in the firm, etc. The nature of the firm includes the types of services the firm performs and how those services make up the total engagements of the firm. For example, does the firm provide an extensive line of services including review, compilation, and attestation engagements?

Firms define engagement quality control review criteria based on the firm's unique circumstances (that is, structure and nature). Accordingly, some firms may establish criteria that result in more EQCRs being performed than other firms. For example, a compilation and review firm with a larger tax practice and a smaller accounting practice may designate that all reviews exceeding an 80-hour time budget have an EQCR performed. For that particular firm, because the firm offers a variety of services overseen by multiple partners, some of whom perform both review and tax services, there may be a more pressing need to have EQCRs performed on a larger number of review engagements. Alternatively, a firm that performs a significant number of reviews may feel more confident in its ability to follow established review guidance because all of its partners routinely perform reviews as a matter of course. Thus, that firm may designate only review engagements that it considers to be high-risk (as defined by the firm) for EQCR. The preceding discussion indicates that different firms may treat the same engagement differently for purposes of establishing engagement quality control review criteria. The key point is that EQCR criteria are as unique as the firm.

For each type of service provided, the firm may consider a different set of EQCR criteria. In other words, the criteria established for review engagements may differ significantly than for other types of attest engagements. As previously mentioned, QC 10.A41 suggests that when establishing criteria for EQCR, firms consider, for example, the nature of the engagement, unusual circumstances or risks of the engagement, and whether other laws or regulations impact EQCR requirements. Additionally, for most firms, the appropriate criteria consists of a mix of considerations and not merely one criterion. Any circumstance that creates an unusual or a higher level of engagement risk ought to be considered in establishing EQCR criteria. Whenever an engagement is subject to a heightened level of risk, the firm may consider it prudent to have a second pair of eyes review the engagement. Regardless of whether a particular engagement meets the firm's stipulated EQCR criteria, any engagement may be selected for EQCR based on risk during the engagement. However, the reverse situation does not hold true. That is, a firm may not choose to opt-out of performing an EQCR when an engagement meets the established EQCR criteria.

Because EQCR criteria is based on each firm's unique circumstances, firms ought to consider revising the established EQCR criteria when firm circumstances change. *PPC's Guide to Quality Control—Compilation and Review* includes an illustration of changing circumstances that trigger the need to revise a firm's EQCR criteria. The firm's quality control system needs to be a dynamic system that changes as the firm changes.

Engagement Level Quality Control Requirements of AR-C 60

AR-C 60 (AR-C 60A, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*), provides general principles for firms to follow when performing an engagement under the SSARS. Among other things, it includes engagement-level quality control requirements that address certain of the quality control elements of QC 10.

The responsibility to ensure compliance with these engagement-level quality control requirements is primarily placed on the engagement partner. However, the related application guidance indicates that the engagement team also has responsibility to implement engagement-level quality control procedures. In meeting the requirements, the engagement team may rely on the firm's quality control system unless the firm or other parties have indicated that it is inappropriate to do so. The following discussion presents an overview of the engagement level quality control requirements of AR-C 60 (AR-C 60A). For more information about the engagement level quality control requirements, related guidance, and how these requirements relate to the quality control elements of QC 10, see *PPC's Guide to Quality Control—Compilation and Review*.

Engagement Partner and Team Competence. AR-C 60.20 (AR-C 60A.20) provides an overarching requirement for the engagement partner to possess appropriate competencies and capabilities that will allow him or her to perform the engagement in accordance with the SSARS. AR-C 60.21dii (AR-C 60A.21dii) also requires that the engagement partner be satisfied that the engagement team possesses appropriate competence and capabilities to

(a) perform the SSARS engagement as required by professional standards and applicable legal and regulatory requirements and (b) issue a SSARS report, if applicable, that is appropriate in the circumstances.

Responsibility for Quality. AR-C 60.21a (AR-C 60A.21a) requires the engagement partner to take responsibility for the overall quality of each SSARS engagement to which he or she is assigned. AR-C 60.A40 (AR-C 60A.A39) stresses that engagement teams have a responsibility to implement quality control procedures that are appropriate to the engagement. Additionally, the engagement partner needs to emphasize the fact that quality is essential when performing an engagement under the SSARS.

Acceptance and Continuance. AR-C 60.21di (AR-C 60A.21di) requires the SSARS engagement partner to be satisfied that the engagement and client relationship acceptance and continuance process was appropriately performed. The engagement partner is also required to consider whether information presented or discovered indicates a lack of management integrity. AR-C 60.A46 (AR-C 60A.A45) further states that if the engagement partner doubts the integrity of management such that the proper performance of the engagement may be affected, not accepting the engagement is appropriate, unless acceptance is required by law or regulation. (Law or regulation requiring acceptance of an engagement seldom, if ever, occurs in the United States of America.)

Engagement Performance. Under AR-C 60.21b (AR-C 60A.21b), the engagement partner is responsible for directing, supervising, planning, and performing the engagement to comply with all applicable professional standards and ethical and legal requirements. AR-C 60.21c (AR-C 60A.21c) indicates that the engagement partner should assume the responsibility for the appropriateness of the accountant's report in the circumstances of the particular engagement.

AR-C 60.21diii (AR-C 60A.21diii) specifies that the engagement partner should take responsibility for ensuring that appropriate engagement documentation is maintained for all engagements performed under the SSARS. This requirement is included in a list of requirements directing the engagement partner to ensure that SSARS engagements are performed in accordance with the firm's quality control policies and procedures. Thus, the requirement is not specific or limited to only assembly of engagement documentation, but is broader, encompassing engagement documentation in totality.

AR-C 60.22 (AR-C 60A.22) requires the engagement partner to inform the firm promptly of any information received after the acceptance or continuance of an engagement, that had the information been known earlier, would have caused the firm to decline the engagement.

Complying with Ethical Requirements. AR-C 60.23 (AR-C 60A.23) requires the engagement partner to be alert throughout the engagement for evidence of noncompliance by anyone on the engagement team. If matters come to the engagement partner's attention that anyone on the engagement team is not in compliance with relevant ethical requirements, the engagement partner, in consultation with others in the firm, should determine an appropriate course of action.

Monitoring. AR-C 60.24 (AR-C 60A.24) indicates that an effective monitoring process is designed to provide reasonable assurance that a firm's quality control policies and procedures are relevant, adequate, and operating effectively. The engagement partner should consider the results of the firm's monitoring process and whether any quality control system deficiencies noted during the most recent monitoring could potentially affect the engagement.

Peer Review Standards

Applicability of Peer Review Requirements. If a CPA firm has an accounting and auditing practice as defined by the Peer Review Standards, the firm should enroll in the AICPA Peer Review Program. [Firms meeting specified criteria are required to have their review administered by the National Peer Review Committee (National PRC)]. *PPC's Guide to Quality Control* provides information on peer reviews of a firm's system of quality control in an accounting and auditing practice. Compilation and review firms generally enroll in the AICPA Peer Review Program because of the types of engagements performed. If the firm does not perform accounting and auditing services as defined by the Peer Review Standards or only performs SSARS preparation engagements, the firm is not required to have a peer review. Individual CPAs in non-CPA owned firms are required to enroll in a peer review program if they perform SSARS compilations and issue compilation reports.

A firm can enroll in the AICPA Peer Review Program by completing the enrollment information in the AICPA's Peer Review Integrated Management Application (PRIMA) system.Beginning in 2017, the AICPA Peer Review Board approved a change to the Peer Review Standards to allow firms without AICPA members to enroll in the AICPA Peer Review Program. Previously, firms without AICPA members could only enroll in a practice monitoring program administered by an appropriate state CPA society. As a result, many of the state CPA societies were administering two programs: the AICPA Peer Review Program and a separate program for firms without AICPA members. Due to the ability of firms without AICPA members to now enroll in the AICPA Peer Review Program, some administering entities have discontinued offering their separate state programs.

The AICPA believes various benefits have been, or will be, realized by having both AICPA member firms and firms without AICPA members participating in the same peer review program. Those benefits include (a) better achieving the AICPA's goal of enhancing audit quality and (b) raising the quality of firms' accounting and auditing practices for all members of the CPA profession, not just AICPA member firms.

To make the transition from a state CPA society program to the AICPA peer review program as smooth as possible, the AICPA will not require a change in the timing of the next peer review if the firm without AICPA members' most recent peer review was administered by an entity approved by the AICPA Peer Review Board. Additionally, there is no requirement for anyone in the nonmember firm to become an AICPA member in order to enroll in the AICPA Peer Review Program. Nonmember firms also join the AICPA Peer Review Program by enrolling online through the PRIMA system, discussed in *PPC's Guide to Quality Control*.

The Code requires members to practice in firms that have quality control procedures for ensuring that services are competently delivered. The bylaws of the AICPA include a requirement at BL 2.2.3 and BL 2.3.4 that persons engaged in *public practice* (the practice of public accounting) as an owner, or as an employee who has been licensed as a CPA for more than two years, either are—

a. practicing in a CPA firm that is enrolled in an AICPA-approved practice monitoring program if the firm performs services that are within the scope of the AICPA's practice monitoring standards and the firm issues reports purporting to be in accordance with the AICPA professional standards, or

b. if authorized by Council, are themselves enrolled in such a program.

Practice monitoring programs help protect the public interest in the quality of accounting, auditing, and attestation services performed by public accounting firms. Additionally, most state boards of accountancy require licensees to undergo practice monitoring, also known as compliance assurance at the state level, to practice in their state, regardless of whether the firm or its personnel are AICPA members.

The types of engagements subject to the AICPA practice monitoring requirement are defined in both the Peer Review and QC standards in the definition of the term *accounting and auditing practice*. The Peer Review Standards (PR 1000.06) state that an *accounting and auditing practice* consists of all engagements performed under the SASs; SSARS (excluding those engagements for which SSARS has provided an exemption); SSAEs; *Government Auditing Standards* (the Yellow Book) issued by the GAO; and PCAOB standards. (However, engagements subject to PCAOB permanent inspection are not included in the scope of the AICPA program.)

QC 10.13 defines an *accounting and auditing practice* as one that performs audit, attestation, compilation, review and any other services for which standards have been promulgated by the ASB or ARSC under the *General Standards Rule* (ET 1.300.001.01) or the *Compliance With Standards Rule* (ET 1.310.001.01), of the Code. Although standards for other engagements may be promulgated by other AICPA technical committees, engagements performed in accordance with those standards are not encompassed in the definition of an *accounting and auditing practice*.

Although there are subtle differences in the wording of the definitions of an accounting and auditing practice as found in the Peer Review Standards and QC 10, it is the AICPA Peer Review Board's intent that the definitions cover the same types of engagements. Accordingly, the types of engagements subject to a firm's peer review are the same types of engagements that should be included in a firm's QC system.

In January 2021, the AICPA released a Q&A document that provides information about the AICPA Peer Review Program and includes peer review questions commonly asked by firms undergoing peer reviews. It is meant to assist firms in understanding requirements related to peer review and provide other general information and resources about peer review. The document is available on the AICPA's website at **https://www.aicpa.org/interestareas/peerreview/resources/faqs/downloadabledocuments/qandaprp.pdf**.

Are SSARS Financial Statement Preparation Engagements Subject to Peer Review? The answer to the question of whether financial statement preparation services performed under the SSARS [AR-C 70 (AR-C 70A)] are subject to peer review is "maybe." To further explain, Interpretation Nos. 7-3 and 7-4 of the Peer Review Standards indicate that when a firm's highest level of accounting service performed is a financial statement preparation, such firms are not required to enroll in the AICPA Peer Review Program and undergo peer review. However, the Peer Review Interpretations go on to state that when the firm either elects to enroll in the program or is already enrolled because of the other types of engagements it performs, the firm's preparation engagements fall within the scope of peer review. (In the situation of a firm enrolled in peer review who has one or more partners who perform only preparation engagements, it is generally necessary for a preparation engagement for each such partner to be selected for review.)

While the AICPA does not require peer review of firms that perform preparation engagements as their highest level of service, practice monitoring requirements of state boards of accountancy may stipulate that firms performing SSARS engagements (which would include preparation services) must have peer reviews. In such circumstances, firms performing only preparation engagements would be subject to peer review. Accordingly, firms need to check with their state boards of accountancy.

Types of Reviews. The Peer Review Standards provide for two types of reviews: a *system review* and an *engagement review*. Firms that perform audit engagements under the SASs or *Government Auditing Standards*, examinations under the SSAEs, or engagements under the PCAOB standards as their highest level of service are required to have a system review every three years. Firms that have an accounting and auditing practice, as defined by the Peer Review Standards, but do not perform the types of engagements that require a system review and instead perform only services under the SSARS or the SSAEs (excluding examinations) are required to have an engagement review every three years, but may elect to have a system review. System reviews are not discussed further in this course since compilation and review firms ordinarily do not undergo system reviews. (Undergoing a system review is covered in *PPC's Guide to Quality Control*.) Firms that do not perform any of the services discussed in this paragraph are not required to undergo peer review. Peer Review Standards Interpretation No. 7-2 explains which type of peer review a firm is required to undergo based on its highest level of service provided.

Engagement Reviews. As discussed in the preceding paragraph, compilation and review firms generally undergo a peer review known as an *engagement review*. The objective of an engagement review is to evaluate whether engagements submitted by the firm under review are performed and reported on in conformity with applicable professional standards in all material respects. In an engagement review, the peer reviewer reads the financial statements or information and the related accountant's report submitted by the reviewed firm. The peer reviewer also considers whether certain background information and representations, and the applicable documentation required by professional standards, are appropriate.

The peer reviewer does not attempt to evaluate the adequacy of the firm's quality control system. As a result, an engagement review does not involve a review of engagement workpapers (other than engagement documentation discussed in the next paragraph), administrative files or personnel files, personnel interviews, or other procedures. Since an engagement review does not evaluate the firm's system of quality control, an engagement review report is very different from a system review report, which expresses an opinion on the firm's QC system. The engagement review report provides assurance only on the firm's engagements submitted for review. Engagement reviews are discussed in detail in *PPC's Guide to Quality Control—Compilation and Review*.

During an engagement review, the following procedures are performed by the reviewer:

a. Consideration of the financial statements or information and the related accountant's report on the preparation, compilation, and review engagements performed under SSARS and engagements performed under SSAEs.

b. Consideration of the documentation in a review engagement for the reviewer to understand the accountant's basis for and development of expectations in applying analytical procedures.

c. Consideration of the documentation on the engagements performed by reviewing background and engagement profile information, representations made by the firm, and inquiries.

d. Review of all other engagement documentation required by applicable professional standards. (Firms must now upload their proof of licensing and individual and firm registration on the PRIMA system.)

Selection of Engagements for Review. In selecting the engagements for review, reviewers use the following guidelines established in the Peer Review Standards:

a. One engagement is selected from each of the following types of services performed by the firm:

   (1) Review of financial statements (performed under SSARS).

   (2) Compilation of financial statements, with disclosures (performed under SSARS).

   (3) Compilation of financial statements that omit substantially all disclosures required by GAAP (or a special purpose framework) (performed under SSARS).

   (4) Engagements performed under the SSAEs other than examinations.

b. One engagement is selected from each individual of the firm (generally a partner) who is responsible for the issuance of the reports listed in item a.

c. Selection of preparation engagements is made only in the following circumstances:

   (1) One preparation engagement with disclosures (performed under SSARS) is selected when performed by an individual in the firm who does not perform any engagements included in item a above or when the firm's only engagements with disclosures are preparation engagements.

   (2) One preparation engagement that omits substantially all disclosures (performed under SSARS) is selected when performed by an individual in the firm who does not perform any engagements included in item a above or when the firm's only omit disclosure engagements are preparation engagements.

   (3) One preparation engagement is selected to meet the requirement in item d below (if needed).

d. Generally, at least two engagements are selected for review.

The criteria listed in items a.–d. are not mutually exclusive. In other words, one of every type of engagement that a partner (or individual if not a partner) performs does not have to be reviewed as long as, for the firm as a whole, all types of engagements noted in item a. performed by the firm are covered. Also, an engagement review does not include tax or consulting services engagements.

The engagements subject to review are those with years (or periods) ended during the year under review. For financial forecasts or projections and agreed-upon procedures engagements, the selection for review generally should be those with accountant's report dates during the year under review. If the current year's engagement has not been completed and a comparable engagement within the peer review year is unavailable, then the prior year's engagement should be reviewed. In addition, if a more recent equivalent (compilation, review, attestation, etc.) engagement for the client has been completed, then the more recent engagement is generally selected.

Procedures Checklists Should Comply with Peer Review and SSARS Standards

Quality Control Materials. An integral part of a firm's QC system is its engagement work programs, checklists, sample confirmations and letters, and other practice aids that help ensure compliance with both authoritative literature and peer review standards. Such systems of practice aids are often referred to as *quality control materials* (QCM).

The checklists presented in *PPC's Guide to Compilation and Review Engagements* are adopted by many firms as their QCM. Likewise, many firms also adopt the checklists and practice aids in PPC's other auditing and accounting manuals as the QCM for their QC systems. During a system review, the review team asks for copies of all QCM used by the firm and whether the firm obtains its QCM from an outside source. If so, the review team will also ask whether the provider of the QCM has undergone a peer review. If not, it is necessary for the peer review team to spend additional time reviewing the appropriateness of the QCM. There is not an evaluation of practice aids in an engagement review, as the focus is on the engagement and not the system of quality control.

However, all firms subject to peer review have responsibilities for the use of quality control materials as stated in the QCM Review Report:

> Users of the materials and this report should carefully consider the scope of this review. They should also understand the intended uses and limitations of the materials as reflected in their user instructions and related information, as well as the level of explanatory guidance provided by the materials. Users of the materials are responsible for evaluating their suitability and implementing, tailoring, and augmenting the material as appropriate. Therefore, the reliability of the materials is also dependent on the effectiveness of these actions and could vary from user to user. Further, there may be important elements of a quality control system in accordance with the Statements on Quality Control Standards that are not included in the materials that have been subject to this review.

Accordingly, it is important for users of QCM to put procedures in place to ensure those responsibilities are met.

PPC's QCM Have Been Peer Reviewed. PPC's system for developing the checklists and practice aids used in its guides has been reviewed. Our peer review report, with a rating of *pass*, is located in the introductory material of *PPC's Guide to Compilation and Review Engagements*. Please direct the peer review team to this report during your peer review. PPC voluntarily elected to undergo this review—

a. To assure users that the QCM in PPC guides conform to both professional standards and quality control standards.

b. To minimize the cost of users' peer reviews.

Code of Professional Conduct

The AICPA *Code of Professional Conduct* sets forth the fundamental principles of professional ethics that should be followed in a SSARS engagement, including those related to integrity, objectivity, and due care. The Code applies to all individuals who are members of the American Institute of Certified Public Accountants. In addition, certain state CPA societies and state boards of accountancy have incorporated all, or parts of, the AICPA Code into their own rules of conduct.

The AICPA and many state CPA societies have joined together to create the Joint Ethics Enforcement Program (JEEP) in order to permit joint enforcement of their respective codes of professional conduct with respect to a member by means of a single investigation. Accordingly, investigative information is shared between the AICPA and the state CPA societies. In addition, the AICPA Professional Ethics Division receives referrals from the various state licensing boards as well as federal agencies such as the Securities and Exchange Commission and various Inspectors General. However, the AICPA cannot revoke a member's license; only the applicable state licensing board can do that. The AICPA can, however, terminate or suspend an individual's membership.

The Code is divided into three parts that separately apply to members in public practice, members in business, and other members (such as retired and unemployed members), as well as a preface that applies to all members. The

Code also provides a numbering system with the reference preface of "ET." In addition, the Code incorporates two broad conceptual frameworks—one for members in public practice and a separate one for members in business. These conceptual frameworks set forth requirements in those situations where the member has identified a threat to compliance with the rules in the Code, and the relationship or circumstance creating the threat is not covered within the Code. Firms can access the online version of the Code at **http://pub.aicpa.org/codeofconduct/Ethics.aspx**.

SELF-STUDY QUIZ

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

17. What element of quality control ensures that the firm has policies and procedures in place that promote an internal culture that recognizes quality is essential to engagement performance?

    a. Engagement performance.

    b. Human resources.

    c. Monitoring.

    d. Tone at the top.

18. Engagement reviewers will select engagements from each of the following service types **except:**

    a. Compilations.

    b. Consulting engagements.

    c. Reviews.

    d. SSAE engagements (not examinations).

SELF-STUDY ANSWERS

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

17. What element of quality control ensures that the firm has policies and procedures in place that promote an internal culture that recognizes quality is essential to engagement performance? **(Page 365)**

    a. Engagement performance. [This answer is incorrect. This element of quality control, per QC 10.17, helps ensure that work performed by engagement personnel consistently complies with applicable professional standards and regulatory requirements, and that the firm issues reports that are appropriate in the circumstances.]

    b. Human resources. [This answer is incorrect. Per QC 10.17, this element of quality control ensures that the firm has sufficient personnel with the competence, capabilities, and commitment to ethical principles to (1) perform engagements in accordance with professional standards and applicable legal and regulatory requirements and (2) enable the firm to issue reports that are appropriate in the circumstances.]

    c. Monitoring. [This answer is incorrect.] This element of quality control, as outlined in QC 10.17, ensures that the policies and procedures established by the firm for the other elements of quality control (including the one described above) are relevant, adequate, and operating effectively.

    d. **Tone at the top. [This answer is correct. QC 10.17 states that a firm's system of quality control should incorporate policies and procedures that address specific QC elements. One such element is leadership responsibilities for quality within the firm (or tone at the top). This element of quality control ensures that the firm has policies and procedures to promote an internal culture recognizing that quality is essential in performing engagements.]**

18. Engagement reviewers will select engagements from each of the following service types **except: (Page 371)**

    a. Compilations. [This answer is incorrect. According to the Peer Review Standards, reviewers will select one compilation of financial statements, with disclosures (performed under SSARS), and one compilation of financial statements that omit substantially all disclosures required by GAAP (or a special purpose framework) (performed under SSARS).]

    b. **Consulting engagements. [This answer is correct. Under the Peer Review Standards, an engagement review does *not* include tax or consulting services engagements.]**

    c. Reviews. [This answer is incorrect. As discussed in the Peer Review Standards, when selecting engagements for an engagement review, the reviewer will select one review of the financial statements (performed under SSARS).]

    d. SSAE engagements (not examinations). [This answer is incorrect. Engagements performed under the SSAEs other than examinations are one of the categories from which engagement reviewers will select engagements for review.]

OTHER ADMINISTRATIVE FORMS THAT MAY BE USED

Introduction

There are other administrative forms accountants might find useful when providing bookkeeping services, which are discussed in the following paragraphs. The forms discussed below are all available in *PPC's Guide to Compilation and Review Engagements*.

Trial Balance Preparation Checklist. This checklist is designed for engagements that entail various bookkeeping services followed by preparation of trial balance and prepared, compiled, or reviewed financial statements. It lists the steps that most firms would want their paraprofessionals to follow in completing the bookkeeping function, preparing the trial balance, and drafting the financial statements.

This form should be used only on an as needed basis. It is not part of the basic practice aids that should be completed on every engagement. Even firms that routinely provide write-up services for their compilation clients may not need the form. For example, smaller practice units in which the CPA is closely associated with the accounting services may find such checklists unnecessary.

Routing Instructions for Processing Financial Statements. This form details the steps normally needed to get the financial statements out the door (that is, typing, proofing, binding, etc.). The form is designed for larger firms that route the work through several departments. It is purely an administrative form, as most firms have developed their own customized forms based on their own internal policies and procedures.

Accounting and Engagement Issues. This form has been designed to provide standardized documentation of both in-firm and outside firm consultations. It provides a roadmap for documenting the resolution of a technical question or problem through consultation. In addition, this form can also be used to document differences of opinion among engagement team members, with those consulted, or between the engagement partner and engagement quality control reviewer concerning engagement issues. Finally, this form may be used to document significant issues, consultations, conclusions, and the basis for conclusions relating to decisions to withdraw from an engagement or from both the engagement and the client relationship. Use of this form is optional and should be only on an as needed basis. It is not part of the basic practice aids that should be completed on every engagement. This form generally should not be used to document general discussions of technical questions or problems initiated among staff personnel. Consultation issues are discussed in more detail later in this lesson.

Report Transmittal Letter—Drafting Form. This form is a drafting form for a report transmittal letter. It provides an example cover letter that can be included with reports delivered to the client. This form is optional and is not part of the basic practice aids that should be completed on every compilation or review engagement.

USING ACCOUNTING SOFTWARE

Introduction

As previously discussed, many compilation and review engagements include various accounting services such as preparing a general ledger, recording journal entries, processing payroll, etc. In fact, providing accounting services and compiled or reviewed financial statements is a common engagement for many practitioners. For example, the product delivered to the client often takes the form of an accountant's report, along with the compiled or reviewed financial statements and general ledger. Many firms utilize accounting software to perform these compilation and review engagements. For example, using the appropriate accounting software, accountants can generate presentation quality financial statements (including footnotes) along with the appropriate accountant's compilation or review report as a byproduct of the accounting services they perform for their client. However, due to the numerous accounting software packages available, it can be difficult for an accountant to select the accounting software that best meets his or her needs. The following section explains what accounting software does, the various types of accounting software, and ways to choose the appropriate accounting software.

What Accounting Software Does. Numerous accounting software programs are available, each capable of handling a variety of tasks. Those tasks include—

- Recording cash receipts and disbursements.
- Maintaining accounts receivable and accounts payable records.
- Recording payroll transactions and producing tax information (e.g., W-2s, 941s, 944s, 1099s, etc.).
- Recording journal entries.
- Generating financial statements.
- Producing an accountant's report on the financial statements.

Types of Accounting Software. Depending on their features, accounting software programs can be loosely classified as either general ledger (G/L) packages or write-up packages.

- G/L packages are integrated accounting software packages designed for active accounting processing (including such functions as generating sales invoices, checks, etc.).
- Dedicated write-up packages are written specifically with write-up engagements in mind. They generally are designed for after-the-fact accounting and include reporting features not found in G/L packages.

The following paragraphs discuss each type of software package in more detail.

General Ledger Packages. G/L packages are integrated accounting programs. That is, the G/L software package often is linked with other modules or programs to comprise an entire accounting system. For example, an integrated system might include various modules for accounts receivable, accounts payable, inventory, and payroll. In such instances, the transactions entered are not only posted to the G/L but produce subsidiary ledgers for those accounts as well. The following are some of the features of a typical G/L package.

- *Client Setup.* The user enters key client data and accounting preferences, such as year-end dates, accounting method, and equity accounts.
- *Account Setup.* A chart of accounts is developed by assigning account numbers and descriptions. Systems vary in the number and types of characters allowed in the account number. Some products force users to select account numbers within a certain range, based on the account's financial statement classification. For example, the software might require that current asset accounts have numbers between 1000 and 1999.
- *Subsidiary Modules.* For many G/L packages, users can buy add-on modules for major accounts and activities such as accounts receivable, accounts payable, inventory, and payroll. Although add-on modules are purchased separately, they link directly with the G/L. Consequently, transactions can be recorded in the G/L directly or through the subsidiary modules.
- *General Journal Entries.* General journal entries (adjustments) are usually entered in a separate journal. Explanations for entries are limited in most products. Journals of activity can be printed and summarized by account.
- *Posting and Period Closing.* Transactions and journal entries can be entered when desired. After the entries for the period are entered, the period is closed (zeroed) and a new one is set up. Special routines are provided for closing the year-end and updating the retained earnings accounts. Transaction detail is normally lost after a year is closed.
- *Reports.* Most packages print G/Ls and subsidiary journals. They also print financial statements, although the options for format and degree of detail may be limited. Many add-on modules generate special reports such as aged accounts receivable and perpetual inventory lists.

Write-up Packages. Like G/L packages, write-up software allows the user to record transactions and generate financial statements. However, these packages have several features suited to the special needs of write-up practices, such as the following:

- *Multiple Client Access.* While many G/Ls are designed to handle only one business, write-up packages can handle multiple clients.
- *Charts of Accounts.* Many write-up packages contain master charts of accounts that can be tailored to the needs of individual clients. Master charts of accounts save time when setting up new clients. Write-up packages are also flexible in account number formats, often allowing more characters and separators (periods, dashes, and slashes) than G/L packages.
- *Custom Data Entry.* Many packages allow users to modify the screen displays used to enter transactions. Transaction data can be modified to be consistent with the layout of client documents, which can reduce the time spent entering data.
- *Data Import.* The client's accounting system data file can be directly imported into the accountant's write-up software. Many packages allow users to import QuickBooks, Excel, and/or CSV (comma separated values) files.
- *Batch Processing.* Transactions can be entered in batches (groups) to improve the accuracy and efficiency of data entry. Batches may be checked for errors by comparing debit, credit, batch, or hash totals.
- *After-the-fact Payroll.* Many write-up packages have modules that record payroll transactions for updating the G/L and printing payroll tax forms such as W-2s, 940s, 941s, and 944s. The payroll capabilities may be standard features of the write-up program or add-on modules.
- *Report Writers.* This is where write-up packages shine. Predefined report layouts can be adapted from a master library or another client. Great flexibility is given to report headings, totaling, and account summarization. The packages often are designed to aid the accountant in producing GAAP financial statements, including cash flow statements. Most programs also provide for automatic production of the accountant's reports and notes to the financial statements.
- *Practice Management.* Some packages include time and billing modules and/or due date monitoring modules and other practice management features.

Selecting a Write-up Software Package. Because numerous accounting software packages are available, selecting the one that best meets the firm's needs can be difficult. Many accountants select a system that meets their immediate needs only to be surprised by future problems and system limitations. Therefore, the authors have developed the following points for consideration when choosing an accounting software package:

- *Analyze Current Operations.* The current system, whether it is useful or useless should be evaluated. Factors such as the number of current clients, the size of the practice, and the types of financial statements frequently generated (for example, special purpose framework vs. GAAP) should be considered.
- *Determine Specific Requirements.* After analyzing the firm's current operations, the specific system needs should be identified. During this process, the firm should accumulate items that are unique to their write-up practice. The list should include mandatory requirements as well as a "wish list" of items that might enhance the firm's practice.
- *Consider the Firm's Computer System.* The firm's computer environment directly impacts the type of accounting software that can be selected. The most common types of computer systems include the following:
    a. *Single Work Station.* This environment includes stand-alone personal computers located at each work station. Software programs are installed on each computer and data files are maintained on disks or the computer's hard drive.
    b. *Local Area Network (LAN).* Generally, if the firm's needs dictate a multi-user environment, local area networks (LANs) are used. LANs allow the firm's personal computers to access each other's files.

Under a LAN system, a firm generally has a computer designated as the central file server that stores all client data files. To work on an accounting engagement, the user copies the data from the file server computer to his or her work station. The accounting services are then performed at the user's work station. After completing the services, the user copies the data back into the central computer file. Under this system, all files are maintained in a single location, making access very easy. However, only one person at a time may work on the files.

c. *Web Portals.* It is becoming more and more common for firms to use web portals, where the software is maintained by the vendor and the CPA logs onto the web to access the software.

- *Reporting Capabilities.* The software's reporting capabilities are an important consideration in selecting an accounting software package. The reporting capabilities of accounting packages can vary. For instance, some accounting programs merely generate a general ledger while others produce presentation quality financial statements for single and comparative periods. In addition, some programs allow the user to modify report headings and account summarizations (for example, to print appropriate special purpose framework financial statement titles).

- *Reporting Flexibility.* Periodically, the firm may need to make reporting changes to comply with various accounting standards. The accounting software package should provide the flexibility to make those changes. It is also beneficial if the accounting software allows the accountant to include note disclosures and produce the accountant's report.

- *Ease of Use.* A significant portion of an accountant's time often is spent inputting data. Therefore, data entry should be easy and quick. When evaluating how easy a system is to use, some of the factors to consider include the following:

  a. *Easy to Learn.* A software system that is easy to learn generally requires minimal staff training. As a result, no one accountant needs to become an indispensable computer operator. If a package requires extensive training and research to operate, it generally will not promote efficiency.

  b. *Easy to Correct Errors.* The software program should allow the accountant to easily correct errors. Some systems require the user to exit one application program and reenter another application program just to correct a coding error. That process can be both time-consuming and inefficient.

  c. *Easy to Set up New Clients.* New client setup should be fast and simple. The firm should look for features such as master charts of accounts and the ability to copy charts of accounts from one client to another.

  d. *Single Key Stroke Options.* Some packages allow single key stroke options that allow the user to repeat the prior transaction's account number by entering a single key rather than reentering the data.

- *Importing Capabilities.* Some packages allow the client's accounting system data files to be directly imported into the accountant's write-up software.

- *Privacy and Security.* The firm must ensure the privacy of financial information. Many software systems can restrict access to financial information.

- *Cost.* If the firm has only a few write-up clients who need only generic financial statements, it might consider the general ledger software packages. However, if the firm has a large write-up practice or several clients with special reporting needs, the additional features found in higher priced write-up packages may be worth the higher cost. When evaluating price, the firm should remember that the purchase price is just one cost to consider. Operating, training, and maintenance costs should also be considered.

- *Remote Entry.* Many accounting software systems can import data from a client's computer system. Consequently, a client can input data into their computer system and transmit it to the firm via modem or computer disk.

- *Payroll.* The firm should determine if it needs after-the-fact payroll or active payroll processing. If the firm prepares its client's payroll tax returns, it should look for a package that can record payroll data (after-the-fact payroll) and prepare the appropriate payroll forms (for example, W-2s, 1099s, 940s, 941s, 944s, and

other forms). Some write-up clients depend on their accountants to compute their payroll and prepare payroll checks. If so, the firm should consider buying software that can handle live payroll. Because most dedicated write-up packages do not have that ability, that may mean the firm needs to buy a general ledger package or a separate payroll package.

- *Account Number Flexibility.* If clients have their own charts of accounts, the accounting software should be able to handle their account number formats.
- *Customization Capabilities.* An important question a firm needs to consider in selecting an accounting software package is whether the software can be customized. If the package can be customized, the firm will also need to consider whether the customization will meet the firm's requirements.
- *Multiple Client Capabilities.* The software should handle multiple clients and allow the accountant to easily change from one client data file to the next.
- *Link to Tax-processing Packages.* Many software packages can link to tax processing programs. Generally, these tax packages allow the firm to transfer client financial information directly into its tax return preparation software without manually reentering the data.
- *Ease of Maintenance.* Many established software manufacturers offer update/enhancement agreements, and on-line and toll-free telephone support agreements at additional cost. It may make sense to purchase both types of those agreements if staff members are not familiar with the software or the firm wants to keep current with the most recent release of the software.
- *Licensing.* Software is usually not sold; it is licensed. Therefore, a firm should review the licensing agreements associated with various software packages. Purchasing a license generally allows the user to install the software on a specific number of computers. If a firm needs its staff members to work on more than one computer, it should either buy multiple copies, buy and install a local area network (LAN), or buy a site license. (The last option is normally only cost-effective when many copies are needed.)
- *Vendor Reliability.* It is important to be sure the vendor is reliable, has sufficient resources to satisfy the firm's requirements, and will be available when needed.

An important aspect in choosing accounting software is knowing what software packages are available. Often there are many choices within each category of accounting software programs (low-cost, mid-range, or high-end). The following are suggested procedures for gathering evidence about specific software packages:

- *Review Product Literature.* Product literature can provide valuable information about a particular software package's specialized capabilities. When a package adequately meets a specific need, that feature will often be touted in product literature. Of course, product literature contains purely promotional material and will always be biased about the product's capabilities. Furthermore, product literature rarely points out a product's weaknesses.

  The firm may obtain product literature by contacting the software developer directly, or, if the product is sold locally, by contacting the local dealer. When contacting a software developer or dealer, the firm should ask about the types of available literature. Some vendors may only send glossy sales promotion literature. Others may send detailed specifications of the product's capabilities and limitations and, possibly, a demonstration disk for review. Vendors also may send either an information packet that includes copies of magazine software reviews or ask permission for a salesperson to call and show their products.

- *Search Online Information Services.* Online information services offer many features including access to various information databases. The databases contain vast amounts of reference data in the form of text, graphics, and programs. The information is usually in specific databases grouped by subject matter, and many of the databases contain information pertaining to computer software packages. By reviewing that information, the firm has up-to-date information about various software packages and can review multiple packages quickly and easily. There are also many commercial services that provide access to database services. *PPC's Guide to Write-Up Services* provides additional information on various online commercial services.

- *Contact the Software Developer Support Line.* The software developer support line can be an excellent source of information about whether a particular package meets the firm's needs. This contact also can reveal the quality of the developer's support line.
- *Contact a Local Dealer or Sales Representative.* A local dealer or sales representative usually can provide information about prices, availability of modules, current versions, and upgrades. Some dealers who are also installers can provide valuable information about a particular package's capabilities. On the other hand, some dealers do not install the software and will be unable to provide insights about its detailed capabilities. As with the product literature, dealers' answers may be biased toward their own software products.
- *Contact Other Current Users.* When contacting software developers or local dealers, the firm should request references from other firms who use the software. The firm may want to contact the references and ask questions similar to the following.
    a. How well is the software working?
    b. What is the quality of vendor support?
    c. Do you have any problems with the system?
    d. Would you recommend the system?
- *Read Accounting Software Reviews.* Generally, there are two types of reviews—single product reviews and comparison reviews. Single product reviews are usually written by someone who has experience with the reviewed software product. The writer's insight may offer an in-depth understanding of the software, but also may express a favorable bias toward the software, especially if the author is a representative of the software company. On the other hand, comparison reviews generally compare many accounting software packages. The reviews are usually prepared by individuals who have worked with many products and can identify the key differences. Although the authors probably do not have in-depth knowledge of all the products reviewed, their comparative reviews are usually less biased than single product reviews. Furthermore, comparative reviews typically have tables comparing features. *PPC's Guide to Write-Up Services* contains a list of accounting software review sources.

INDEPENDENCE ISSUES THAT RELATE TO COMPILATION AND REVIEW ENGAGEMENTS

Independence is an important issue for many small practitioners because the only type of report a CPA can issue on financial statements of a nonpublic entity when he or she is not independent is a compilation report. Independence must be assessed in a compilation engagement; and if the CPA is not independent, the lack of independence must be noted in the report. In addition, AR-C 70 (AR-C 70A) financial statement preparation engagements do not include a report and do not require the assessment of independence. However, AR-C 70.A5 (AR-C 70A.A5) notes that accountants who also perform attest services for their financial statement preparation clients need to consider independence.

However, independence is much easier to define than to apply. An infinite variety of situations can occur that raise questions regarding independence issues but are not necessarily independence problems. Therefore, it is important for CPAs to understand the various rules and regulations that govern independence. The following paragraphs discuss the authoritative literature relating to independence and provide some examples of client services or situations that might impair an accountant's independence.

Authoritative Literature Relating to Independence

The primary rules governing independence are found in the AICPA *Code of Professional Conduct* (Code). The authors recommend that the CPA read ET 1.200 of the Code for guidance concerning independence.

Independence requirements also can be found in the SSARS, auditing standards, and statements on standards for attestation engagements. While the authoritative literature governing these various types of engagements contains a

great deal of discussion about the concepts of independence, identifying independence problems, and about resolving nonindependence situations, the basic concept of independence is the same regardless of the level of service or the type of engagement. Basically, accountants are independent if they are free from obligation to or interest in their clients.

In addition, QC 10 imposes independence requirements on accountants, including requiring the firm, at least annually, to obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent. The representations should indicate whether the employee is complying with all of the requirements of ET 1.200 of the Code, as well as the rules of state boards of accountancy and applicable regulatory agencies. Additional guidance regarding QC 10 can be found in *PPC's Guide to Quality Control—Compilation and Review*.

Conceptual Framework for Independence. The Professional Ethics Executive Committee's (PEEC) Conceptual Framework for AICPA Independence Standards (ET 1.210.010 of the Code) describes the risk-based approach used by PEEC to determine whether a member's relationship with a client poses an unacceptable risk to the member's independence.

No Independence Interpretations or Rulings. In situations where there are no independence interpretations or rulings that address an accountant's particular independence circumstance, ET 1.210.010.01 of the Code requires the accountant to evaluate whether his or her particular independence situation would lead a reasonable person who is aware of all of the facts to conclude that the accountant is not independent. When making that determination, accountants should refer to the risk-based approach described in the Conceptual Framework for AICPA Independence Standards.

Required Documentation. If the threats to independence are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level. In instances where threats to independence are not at an acceptable level, thereby requiring safeguards, the following should be documented:

- The threats identified.
- The safeguards applied to eliminate the threats or reduce them to an acceptable level.

Unacceptable Risk. The Introduction to the Conceptual Framework for AICPA Independence Standards indicates that under a risk-based approach to analyzing independence, a member's relationship with a client is evaluated to determine whether it poses an unacceptable risk to the member's independence. Risk is unacceptable if the relationship would compromise (or would be perceived as compromising by an informed third party having knowledge of all relevant information) the member's professional judgment when rendering an attest service to the client.

Threats. Threats to independence are circumstances that could impair independence. Many different circumstances (or combinations of circumstances) can create threats to independence. Some examples include the following:

- *Self-review Threat.* Reviewing your own nonattest work, or that of your team, as part of the attest engagement.
- *Advocacy Threat.* Actions that promote an attest client's interests or position, such as representing a client in tax court.
- *Adverse Interest Threat.* Actions or interests between the accountant and the client that are in opposition, such as a threat of litigation by either party.
- *Familiarity Threat.* Accountants who have close or longstanding relationships with attest clients.
- *Undue Influence Threat.* Attempts by an attest client's management to exercise influence over the accountant, such as pressure to reduce audit procedures for the purpose of reducing audit fees.
- *Financial Self-interest Threat.* Potential benefit to an accountant from a financial relationship with an attest client, such as excessive reliance on revenue from a single attest client.

- *Management Participation Threat.* Performing management functions on behalf of an attest client, such as making hiring decisions.

Safeguards. Safeguards are controls that mitigate or eliminate threats to independence. To be effective, safeguards must eliminate the threat or reduce to an acceptable level the threat's potential to impair independence. There are three broad categories of safeguards:

- *Safeguards Created by the Profession, Legislation, or Regulation.* Examples include continuing education requirements on independence and ethics, and external review of a firm's quality control system.
- *Safeguards Implemented by the Attest Client.* Examples include a tone at the top that emphasizes the attest client's commitment to fair financial reporting, and policies and procedures that are designed to achieve fair financial reporting.
- *Safeguards Implemented by the Firm.* Examples include rotation of senior personnel who are part of the attest engagement team, and the involvement of another firm to perform part of an audit.

Impairment of Independence by Unpaid Fees

An accountant's independence can be impaired by unpaid fees. Specifically, ET 1.230.010.02–.03 of the Code states that an accountant's independence is considered impaired if fees (billed or unbilled) for professional services rendered more than one year prior to the date of the accountant's report remain unpaid when the current year's report is released. (While ET 1.230.010.02–.03 does not indicate that the unpaid fee must be of a certain amount before it impairs independence, the authors believe that clearly inconsequential amounts would not impair independence.) Generally, the engagement partner assigned to each client is aware of not only the status of uncollected fees, but also unbilled fees applicable to that client. Accordingly, the authors believe that the engagement partner (or the in-charge accountant under the engagement partner's supervision) should have the primary responsibility for determining if there are unpaid fees that would impair the firm's independence. That partner should determine that all prior year's fees (including tax and consulting engagement fees) are collected before the current year's report is issued.

Does Providing Accounting/Write-up Services Impair a CPA's Independence?

For a small business engagement, a frequent concern about meeting independence requirements is the effect of providing accounting assistance to the client. An accountant may be asked to provide accounting services to clients who are too small to employ an adequate accounting staff and concerns may arise that the accountant's independence has been impaired in these circumstances. In addition, for many small businesses, the accountant serves as a primary business consultant and may unknowingly be providing services as part of a compilation or review engagement that impair his or her independence. The following paragraphs discuss the effects of accounting/write-up services on independence and specifically address ET 1.295 of the Code.

Nonattest Services. ET 0.400.04 of the Code defines an *attest engagement* as an engagement that requires independence. Audits, examinations, agreed-upon procedures engagements, reviews, and compilations are, therefore, attest engagements. With the exception of compilations, attest engagements cannot be performed if the accountant's independence is impaired; compilations can be performed provided the accountant's report discloses the lack of independence. ET 1.295 of the Code describes the requirements that must be met in order for the performance of nonattest services for an attest client to *not* impair independence:

- *The Client Agrees to Perform Certain Functions.* The accountant should be sure that the client is in a position to make an informed judgment on the results of the nonattest services and that the client understands its responsibilities to—
  a. Assume all management responsibilities.
  b. Oversee the service by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, or experience.
  c. Evaluate the adequacy and results of the services performed.

d. Accept responsibility for the results of the services.

The accountant should also assess and be satisfied that the designated individual who will oversee the services sufficiently understands the services to be performed by the accountant to ensure oversight. Also, the accountant ought to assess the suitability of their skills, knowledge, and/or experience. In cases where the client is unable or unwilling to assume all of these responsibilities, or is unwilling to carry out such responsibilities, the accountant's performance of the nonattest services would impair independence.

- *The Member Should Not Assume Management Responsibilities.* Independence is considered to be impaired if an accountant (or his or her firm) assumes management responsibilities. However, the accountant may assist management in those responsibilities.
- *The Understanding Between the Member and the Client Should be Documented in Writing.* To help prevent any type of misunderstanding with the client, ET 1.295.040.01 states that *before* performing the nonattest services, the accountant should document in writing his or her understanding with the client regarding the following—

  a. Objectives of the engagement (i.e., the nonattest services).

  b. Services to be performed.

  c. Client's acceptance of its responsibilities.

  d. Accountant's responsibilities.

  e. Any limitations of the engagement.

  There are no specifications on how the written understanding is to be documented, so the accountant has flexibility. For example, the understanding might be documented in a separate engagement letter, in the workpapers, in an internal memo, or in the engagement letter obtained in conjunction with an attest engagement. The authors believe it is common in many small business engagements for the accountant to also provide nonattest services, such as tax return preparation or bookkeeping services. Another option would be to document the understanding with the client about the performance of nonattest services in a checklist such as the one provided in *PPC's Guide to Compilation and Review Engagements*.

Certain activities performed as part of a nonattest service are considered to be management responsibilities, and therefore impair independence regardless of whether the accountant complies with the other requirements of ET 1.295 of the Code. In addition, if an accountant assumes a management responsibility for an attest client, the management participation threat created would be so significant that no safeguards could reduce the threat to an acceptable level. The Interpretation lists common nonattest service activities and notes whether they are or are not considered to impair independence. ET 1.295.030.02 specifically states that performance of the following activities would be considered a management responsibility, and would therefore impair an accountant's independence (that is, they would preclude the accountant from being independent):

- Setting policies or strategic direction for the client.
- Directing or accepting responsibility for the actions of the client's employees, except to the extent permitted when using internal auditors.
- Exercising authority on behalf of a client, such as authorizing, executing, or consummating a transaction, or having the authority to do so.
- Preparing source documents, in electronic or other form, that evidence the occurrence of a transaction.
- Having custody of client assets.
- Deciding which of the accountant's or other third parties' recommendations should be implemented or prioritized.
- Reporting to those in charge of governance on behalf of management.

- Serving as a client's stock transfer or escrow agent, registrar, or general counsel.
- Accepting responsibility for the management of a client's project.
- Accepting responsibility for the preparation and fair presentation of the client's financial statements in accordance with the applicable financial reporting framework.
- Accepting responsibility for designing, implementing, or maintaining internal controls.
- Performing ongoing evaluations of the client's internal control as part of its monitoring activities.

ET 1.295.160 of the Code also addresses tax compliance services. Preparing a tax return and transmitting the tax return and related payment, either electronically or in paper form, to a taxing authority does not impair independence as long as the accountant does not have custody or control of the client's funds and the individual overseeing the tax services (a) reviews and approves the return and payment and (b) signs the return prior to transmittal, if required for the filing. Signing and filing a tax return impairs independence unless the accountant has legal authority to do so and—

- the taxing authority has prescribed procedures, allowing the taxpayer to permit the accountant to sign and file a return on their behalf, that meet the standards for electronic return originators and officers outlined in IRS Form 8879, or
- an individual in client management who is authorized to sign and file the tax return provides the accountant with a signed statement that indicates—
  - The return being filed.
  - That the individual is authorized to sign and file the return.
  - That the individual has reviewed the return, including accompanying schedules, and it is true, correct, and complete to the best of their knowledge and belief.
  - That the individual authorizes the accountant to sign and file the return on behalf of the client.

Also, the accountant's representation of the client in an administrative proceeding before a taxing authority does not impair independence providing that the accountant obtains the client's agreement prior to committing the client to a specific resolution with the taxing authority. Independence is impaired if the accountant represents the client in court or in a public hearing to resolve a tax dispute.

In addition, under ET 1.295.110 of the Code, certain appraisal, valuation, or actuarial services are considered to impair independence. Performing appraisal, valuation, or actuarial services impairs independence if the results are material to the financial statements and the service involves significant subjectivity. For example, a material asset appraisal or business valuation generally involves significant subjectivity, and therefore would impair independence if performed for financial statement purposes. However, an actuarial valuation of a client's pension liabilities ordinarily does not require significant subjectivity and, therefore, would not impair independence even if the amount was material.

Under ET 1.295.140 of the Code, certain types of forensic accounting services may impair independence. Independence is impaired if an accountant conditionally or unconditionally agrees to provide expert witness testimony for a client. However, under certain defined conditions, independence is not impaired if the accountant provides expert witness testimony for a large group of plaintiffs or defendants that includes the accountant's client. If the accountant provides litigation services where he or she is a trier of fact, special master, court-appointed expert, or arbitrator in a matter involving a client, independence is impaired.

In some cases, the accountant may assist with the client's internal audit function. ET 1.295.150 of the Code also addresses the impact of those services on the accountant's independence. Performance of internal audit assistance services does not impair the accountant's independence as long as the accountant is not an employee of the client or does not act in the capacity of management (for example, determining the scope, risk, and frequency of internal audit activities). The accountant should be satisfied that the client (a) understands its responsibility for internal controls

(including ongoing monitoring) and (b) understands its responsibility for directing the internal audit function. The general requirements for the performance of nonattest services discussed earlier in this section (such as documenting the understanding with the client) also must be met. With respect to providing assistance with the internal audit function, the accountant should be satisfied that those in charge of governance are fully informed of the engagement.

Although performing an individual nonattest service might not impair independence, the cumulative effect of multiple nonattest services can increase the significance of threats to independence. As discussed in ET 1.295.020 of the Code, before agreeing to perform the services, the member should evaluate whether the aggregate effect of performing multiple nonattest services results in a significant threat to independence that cannot be reduced to an acceptable level by the application of safeguards. If there are no safeguards that eliminate the threat or reduce it to an acceptable level, the member's independence would be impaired. It is not necessary to consider threats that might be created when other network firms within the member's firm's network provide nonattest services.The accountant should document whether the performance of multiple nonattest services for the client creates a threat to independence. One method for doing so is using the checklists found in *PPC's Guide to Compilation and Review Engagements*.

Should Proposing Journal Entries and Preparing Financial Statements in Connection with a Compilation or Review Be Viewed as Bookkeeping and, Therefore, Nonattest Services? ET 1.295.120.01 of the Code includes bookkeeping as an example of a nonattest service. Rather than define bookkeeping, ET 1.295.120.02 provides several examples of services that would be considered bookkeeping. Two of those examples are (a) proposing standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client and (b) preparing financial statements based on information in the trial balance. Practice questions have arisen as to whether those examples mean that proposing journal entries and preparing financial statements in connection with a compilation or review should be viewed as bookkeeping and, therefore, nonattest services. ET 1.295.010.06 of the Code considers activities such as financial statement preparation, cash to accrual conversions, and reconciliations performed by the member to be nonattest services, even if the services are performed as part of the attest engagement. Nonattest services performed for an attest client will not impair a firm's independence as long as the safeguard requirements of ET 1.295 are met.

Additional Questions in Applying ET 1.295 of the AICPA *Code of Professional Conduct*. The following are questions that are likely to arise as accountants apply the requirements of ET 1.295. The responses reflect the authors' views on such matters based on the requirements of ET 1.295.

a. *Impact on Compilation and Review Services.*

- *Question*—How does ET 1.295 affect compilation and review services?
- *Response*—If the accountant performs nonattest services for a compilation or review client, independence will be impaired if *any* of the following occurs:

  (1) The accountant assumes management responsibilities.

  (2) The client is unwilling or unable to: assume *all* management responsibilities; oversee the service by designating an individual, preferably within senior management, who possesses suitable skill, knowledge and/or experience; and evaluating the adequacy and results of, and accepting responsibility for, the services provided.

  (3) The accountant does not establish the understanding with the client regarding: the objectives of the engagement, the services to be performed, the client's acceptance of its responsibilities, the accountant's responsibilities, and any limitations of the nonattest engagement.

  If independence is impaired, the accountant may still issue a compilation report as long as the report is modified to indicate the lack of independence. The following sentence should be added to the report to

indicate the lack of independence. The reason(s) for the lack of independence may also be added, if desired.

> We are not independent with respect to the entity.

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

(1) We are not independent with respect to the entity as of and for the year ended December 3, 20XX, because a member of the engagement team had a direct financial interest in the entity.

(2) We are not independent with respect to the entity as of and for the year ended December 31, 20XX, because an immediate family member of one of the members of the engagement team was employed by the entity.

(3) We are not independent with respect to the entity as of and for the year ended December 31, 20XX, because we performed certain accounting services that impaired our independence.

b. *Providing Routine Advice to Clients.*

- *Question*—If a client calls the accountant and asks a technical question, would this be considered a nonattest service for which ET 1.295 would apply?
- *Response*—No, routine activities performed by the accountant, such as providing advice and responding to clients' technical questions as part of the normal client-accountant relationship, are not considered nonattest services for which ET 1.295 would apply.

  However, the accountant should exercise judgment in determining whether his or her involvement is so extensive (i.e., due to the number or frequency of such routine activities) that it constitutes performing a separate service that would be subject to the ET 1.295 requirements.

c. *Documentation Requirements.*

- *Question*—Does the documentation requirement apply to all client engagements, and does the documentation have to be in the form of an engagement letter?
- *Response*—No, the documentation requirement only applies to nonattest services (for example, bookkeeping, tax, financial statement preparation, or consulting services) performed by the accountant for an attest client when the accountant wishes to remain independent.

  The accountant is required to document his or her understanding regarding the nonattest services with the attest client, but no specific form of documentation is required. Consequently, the required nonattest services understanding might be documented in an attest engagement letter, in a separate nonattest services engagement letter, in a separate workpaper, or in an internal memo.

d. *Inadvertent Noncompliance.*

- *Question*—What if the accountant inadvertently fails to comply with the requirement to document in writing the accountant's understanding with the client?
- *Response*—A failure to document the understanding with the client is not considered to impair a member's independence provided such understanding has been established. Rather, failure to document this understanding is considered a violation of the *Compliance With Standards Rule* of the AICPA Code (ET 1.310).

  In addition, the peer review checklist states that if the accountant is not in compliance with the documentation requirements, then the accountant must provide convincing evidence in order to enable the reviewer to conclude that an independence impairment does not exist.

e. *Independence Rules of Other Regulatory Bodies.*

- *Question*—If the accountant performs attest services for his or her client and the work is subject to oversight by other regulatory bodies (e.g., Government Accountability Office, Department of Labor, and Securities and Exchange Commission), how does the "Nonattest Services" subtopic (ET 1.295) apply?

- *Response*—The requirements of the "Nonattest Services" subtopic must be met, along with any independence rules of the applicable regulatory body that are more restrictive than the requirements of the Interpretation. Failure to comply with independence rules of the regulatory body relating to nonattest services would constitute a violation of the Independence Rule (ET 1.200.001).

f. *Documentation of Assessment of Suitable Skills, Knowledge, and Experience (SKE).*

- *Question*—Does the accountant have to document satisfaction of the SKE of the individual overseeing the nonattest services?

- *Response*—No. However, in peer review, firms have to answer questions in regards to independence and performing nonattest services as part of the engagement questionnaire completed for each engagement selected for review. One of those questions asks the firm to describe their assessment and factors leading to their satisfaction that the client personnel overseeing the nonattest services had sufficient SKE to oversee the nonattest services. This assessment should be documented, possibly by using the checklist provided in *PPC's Guide to Compilation and Review Engagements*.

g. *Third-party Outsourcing.*

- *Question*—Can the client contract with a third party to oversee the accountant's performance of the nonattest services?

- *Response*—Yes. The attest client can outsource the nonattest services oversight functions to a third party. That third party would then serve as the individual designated by management to oversee the nonattest services.

h. *Client Approval of Proposed Journal Entries.*

- *Question*—Is the accountant required to document the attest client's review and approval of accountant proposed journal entries?

- *Response*—No. However, the accountant may choose to document the name of the client individual who reviewed and approved the journal entries and the date of his or her review in order to provide evidence that the accountant did not assume management responsibility of reviewing and approving the entries.

i. *Assessing Whether an Individual Possesses Suitable Skill, Knowledge, or Experience.*

- *Question*—How does an accountant assess a client's designated employee possesses suitable skill, knowledge, or experience as required by the Interpretation?

- *Response*—It is not intended that the client's employee possess a level of technical expertise equal to the accountant's. The client employee need only understand the nonattest services enough to be able to provide general direction for the services; understand the key issues the accountant identifies; make any required management decisions; and evaluate the adequacy of, and accept responsibility for, the results of the accountant's work. This may mean the accountant will need to educate his or her client in order to allow them to assume these responsibilities. For example, if the accountant performs routine bookkeeping services for an attest client, he or she could ensure compliance with the requirements of the Interpretation by reviewing the proposed journal entries with the client and explaining in general terms how each entry affects the financial statements. The client should then be in a position to approve the journal entries and accept responsibility for the financial statements.

j. *Nonattest Services Performed before the Client Becomes an Attest Client*

- *Question*—The accountant accepts a compilation or review engagement for a client for whom he or she has previously provided only bookkeeping services. Prior to accepting the attest engagement, the practitioner does not have a written understanding with the client under ET 1.295 of the AICPA Code. Has the practitioner violated the documentation requirement of the "Nonattest Services" subtopic? Is the practitioner's independence impaired?

- *Response*—The ET 1.295 documentation requirement does not apply to nonattest services performed before the client becomes an attest client. The accountant would be permitted to prepare the required documentation upon acceptance of the compilation or review engagement, provided the accountant is able to demonstrate his or her compliance with the other general requirements during the period covered by the financial statements, including the requirement to establish an understanding with the client.

  The practitioner's independence would not be impaired when the practitioner performed nonattest services that would have impaired independence during the period covered by the financial statements, provided that the nonattest services were provided prior to accepting the attest engagement, the nonattest services were for a period prior to the financial statement period, and the financial statements for the period to which the nonattest services relate were reviewed or audited by another firm.

  As a practical matter, practitioners who are initially engaged to only provide nonattest services but expect to subsequently be engaged to also provide attest services should consider structuring the engagement so that performance of the nonattest services will not impair independence for the attest services.

Illustrative Examples. Independence is much easier to define than to apply. An infinite variety of situations can occur that raise questions about independence but are not necessarily impairment problems. The following paragraphs provide several scenarios relating to accounting services in which accountants' independence might be impaired. Also included with each scenario is the authors' views (considering the guidance in ET 1.295 of the AICPA Code and related nonauthoritative guidance) about whether or not the services are permitted under ET 1.295 (that is, whether or not the services impair the accountant's independence).

a. **Scenario:** A CPA accepts the responsibility of signing or cosigning a client's checks in emergency situations.

   Is Independence Impaired? Yes, independence of the CPA would be considered to be impaired since such activities are considered management responsibilities. Having the authorization to sign or cosign checks on a client's bank account, even if such activity is never performed, impairs independence.

b. **Scenario:** A CPA performs payroll services for a client including preparing payroll tax forms and returns (for example, Form 941, Form W-2, etc.) and preparing semimonthly payroll checks. The CPA also cosigns each payroll check on behalf of an officer of the client.

   Is Independence Impaired? Yes, independence of the CPA would be considered to be impaired because having the authorization to sign or cosign checks on a client's bank account is a management responsibility. Preparation of payroll tax returns also impairs independence unless the requirements outlined earlier in this section are met. In addition, making electronic payroll tax payments does not impair independence provided the payments are made in accordance with U.S. Treasury Department or comparable guidelines and the client has made arrangements for its financial institution to limit such payments to the named payee.

c. **Scenario:** When performing monthly accounting services for a client, the CPA codes the check stubs (that is, determines the general ledger accounts to which the disbursements should be recorded and writes the appropriate account numbers on each check stub) based on the description included by the client on the check stubs.

Is Independence Impaired? No, independence is not impaired. Normally, coding check stubs will not impair the accountant's independence as long as the client provides sufficient detail to clearly identify the nature of each transaction. Note that, in some cases, the accountant can determine the nature of a transaction based on who the check has been issued to (for example, the electric company, office supply company, etc.). However, the accountant should be careful not to assume the role of management, thereby losing independence with respect to the client.

d. **Scenario:** A CPA records journal entries in the client's accounting system.

   Is Independence Impaired? No, the accountant's independence would not be impaired provided that the client understands the nature and impact of the journal entries. For example, the accountant could provide the client with a printout of proposed journal entries accompanied by clear explanations, ask the client to review the printout, and then ask whether the client has any questions about the entries. Although not required, some accountants obtain the client's written approval of the proposed journal entries by, for example, signing or initialing the journal entries or on a separate journal entry approval form, such as the one included in *PPC's Guide to Compilation and Review Engagements*. If a representation letter is obtained (as in a review) such language might also be included in the representation letter.

e. **Scenario:** A CPA installs pre-packaged accounting software, such as QuickBooks®, for his or her client and sets up the chart of accounts and financial statement format defaults.

   Is Independence Impaired? No, the CPA's independence is not impaired. In its *Background and Basis for Conclusions*, the Professional Ethics Executive Committee states that independence is not considered impaired, as this type of service does not constitute "designing" a system, provided the CPA does not create or change the source code(s) underlying the pre-packaged software.

The AICPA has an Ethics Hotline where members of the AICPA's Professional Ethics Team answer questions about independence and other behavioral issues. The toll-free number for the Ethics Hotline is (888) 777-7077.

Independence Interpretation on Hosting Services. ET 1.295.143, *Hosting Services*, under the *Independence Rule* (ET 1.200.001) indicates that hosting services are nonattest services that involve the AICPA member accepting responsibility for the following:

a. Being the sole host of a financial or nonfinancial information system of an attest client.

b. Having sole custody of or storing an attest client's data or records, and the data or records are not available to the attest client except from the member.

c. Providing back-up services or other electronic security services for an attest client's data or records.

When an AICPA member provides any of the above services, the interpretation indicates that the member is maintaining the internal control over the attest client's data or records. Accordingly, a management participation threat to the member's compliance with the *Independence Rule* would not be at an acceptable level and no safeguards could reduce the threat to an acceptable level. Thus, the member's independence would be impaired.

The interpretation provides a list of hosting services activities that would and would not impair independence. The types of hosting services that would impair the member's independence include:

- Housing the attest client's website or other nonfinancial information system.
- Keeping the attest client's data or records on behalf of the attest client. For example, the client's general ledger information, depreciation schedule or other supporting schedules, legal documents, etc., whether maintained electronically or in hard copy format.
- Providing back-up services for the attest client's data or records.
- Serving as the client's business continuity or disaster recovery provider.

The AICPA Professional Ethics Division provides a podcast that highlights issues relating to ethics and independence and has produced several episodes that discuss hosting services. The podcast episodes can be accessed at

https://www.aicpa.org/interestareas/professionalethics/ethically-speaking.html. In addition, several of these hosting services issues are addressed in the AICPA's Nonattest Services FAQs available at **https://www.aicpa.org/content/dam/aicpa/interestareas/professionalethics/resources/tools/downloadabledocuments/nonattestservicesfaqs.pdf**. Following are some questions that the author's believe are most likely to arise when accountants apply the requirements of ET 1.295.143. The responses reflect the authors' views on such matters based on the requirements of the Interpretation.

a. *Third-party Subscription Clearinghouse.*

- *Question*—If a member uses a third-party subscription clearinghouse to issue attest reports, is the subscription clearinghouse considered to be the member's portal?
- *Response*—The subscription clearinghouse would not be considered a member's portal as long as all of the following conditions are met:

  (1) The platform is a document repository set up with the purpose of facilitating document exchange between users.

  (2) The platform is hosted, run, and controlled completely by a third-party vendor that is not the member.

  (3) The member, attest client, and all other subscription clearinghouse members have their own user agreements with the third-party vendor.

b. *Terminating an Attest Client's Access to Portal to Avoid Providing Hosting Services.*

- *Question*—Interpretation ET 1.295.143 indicates that members should terminate an attest client's access to data in the portal within a reasonable period of time after the conclusion of an engagement in order to avoid providing hosting services. What is considered a reasonable period of time?
- *Response*—Professional judgement should be used when determining what a reasonable period of time should be for specific data and records. The period of time should be a limited duration, and allow a sufficient, but not extensive, amount of time for clients to remove the information from the portal and not cause undue hardship to the member or the client. A period of time that is consistent with the member's documentation retention policy or a statute of limitations that continues for multiple years would be considered extensive and not limited in duration. Some situations may consider a reasonable period of time to be relatively brief, such as 60 days, while in other situations a reasonable period of time may be closer to a year in order to avoid undue hardship for the member and the client.

c. *Original Data and Records.*

- *Question*—If a member returns an attest client's original data or records used to perform a nonattest service but retained a copy as documentation to support the member's work, would the member be providing hosting services if they subsequently comply with the attest client's request to provide another copy of its data or records?
- *Response*—ET 1.295.143 allows a member to retain copies of an attest client's original records as documentation that supports the work performed by the member. Occasional requests made by the client for original data or records would not indicate that the member is providing hosting services. However, members should be alert for situations in which client's repeatedly request copies of data or records, which may signify that the member is providing hosting services by de facto. In such situations, the member should evaluate whether a de facto relationship exists and consider its impact on independence.

d. *Providing an Attest Client with Accounting or Other Records Prepared by a Member (which they were not Specifically Engaged to Prepare).*

- *Question*—To avoid impairing independence, when should a member provide an attest client with accounting or other records that the member prepared (but was not specifically engaged to prepare) and that are not in the attest client's books and records or not otherwise available to the attest client?

- *Response*—If such information is necessary for the attest client to accept responsibility for the permissible nonattest service as required by the "general Requirements for Performing Nonattest Services" interpretation, the member should provide the attest client with the information at the time the nonattest services are completed (as opposed to when the attest client makes the request). When the client is not an attest client, members do not need to apply the *Independence Rule* and related interpretations and should instead refer to the *Records Request* interpretation, (ET 1.400.200) to understand when this information needs to be provided in order to avoid a violation of the *Acts Discreditable Rule* (ET 1.400.001).

DEALING WITH ANY CONSULTATION OR DIFFERENCES OF OPINION THAT OCCUR DURING COMPILATION AND REVIEW ENGAGEMENTS

When performing compilation and review engagements, accountants may need to consult with someone not involved in the engagement on complex technical or ethical issues. However, accountants often have certain questions and concerns regarding that consultation. For example, "Are accountants *required* to resolve complex technical questions through consultation when performing compilation and review engagements? If consultation is used, when and what should the workpapers document?" To help practitioners sort through some of these concerns, the following paragraphs address some of the issues regarding consultation in compilation and review engagements.

Do the Standards Require Accountants Performing Compilation and Review Engagements to Resolve Complex Technical Issues through Consultation?

A good starting point for understanding whether the standards require consultation is a quick review of the authoritative literature as it relates to consultation. The SSARS require the accountant to possess or obtain a level of knowledge of the accounting principles and practices of the client's industry. Such knowledge may be obtained, among other ways, by consulting in-firm or outside firm individuals. In addition, QC 10.37 indicates that CPA firms should establish quality control policies and procedures over consultation to provide the firm with reasonable assurance that—

- Consultation takes place when appropriate (such as when dealing with complex, unusual, unfamiliar, difficult, or contentious issues).
- Sufficient and appropriate resources are available to enable appropriate consultation to take place.
- The nature and scope of such consultations are documented and are understood by both those seeking consultation and the individual consulted.
- The consultation conclusions reached are documented and implemented.

Finally, ET 1.300.010.03 of the Code recognizes that consultation with others may be necessary during the performance of professional services. Based on this guidance, the authors believe that, in the appropriate circumstances, the standards indicate that accountants may need to resolve complex technical issues through consultation when performing compilation and review engagements.

When to Document Consultation

To help practitioners determine when to document consultations, the authors suggest the following:

a. *Questions, Discussions, and Research Matters Regarding Unusual, Controversial, or Complex Accounting, Procedural, or Reporting Issues that Are Material in Nature Generally Should Be Documented.* Examples include—

   - An engagement in which a qualified or nonstandard report is likely.
   - An engagement involving material litigation.
   - First time application of new or complex technical pronouncements.

- Industries with special accounting, auditing, or reporting requirements.
- Emerging practice problems.
- Choices among alternative generally accepted accounting principles upon initial adoption or when an accounting change is made.
- Reissuance of a report, consideration of omitted procedures after a report has been issued, or subsequent discovery of facts that existed at the time a report was issued.
- Filing requirements of regulatory agencies.

(Some firms specify situations that require consultation and documentation in the firm's quality control policies and procedures. In those situations, the firm should ensure that all personnel are aware of, and recognize, situations where firm policy requires consultation and documentation.)

b. *Questions, Discussions, and Research Matters of a General Nature or of Minor Technical Importance Generally Do Not Require Documentation.* The decision of whether a question is of a general nature or of minor technical importance versus one that is unusual or controversial and material should be made by the engagement partner or under his or her supervision. Once the determination is made that the issue is unusual or controversial and material, the firm should follow consistent documentation procedures.

In-firm Consultation versus Outside-firm Consultation

Many practitioners tend to think of consultation only in terms of consultation with experts outside their firms. However, consultation includes both consultation within and outside the firm.

In-firm Consultation. Consultation within the firm includes making use of the technical reference materials in the firm's library as well as seeking the personal expertise of other individuals within the firm. In fact, some firms designate a particular person to become an expert in unusually complex areas, such as leases or pension plans. The extent of specialization varies with firm size and individual firm preference. Naturally, the smaller a firm is, the less likely the firm has specialists available for consultation.

At a minimum, for in-firm consultation, the authors suggest that a firm include in its professional library (or have ready access to) the following.

a. *AICPA Pronouncements.* The AICPA, through its senior and technical committees and task forces, issues pronouncements that govern a wide range of topics including accounting, auditing, compilation, review, and other professional services; professional ethics; and quality control. Its pronouncements can be found in the following resources.

(1) *AICPA Professional Standards.* This resource contains all of the currently effective pronouncements on professional standards issued by the AICPA, the International Federation of Accountants, and the International Accounting Standards Board. Consequently, it includes Auditing Standards, Statements on Standards for Attestation Engagements, Statements on Standards for Accounting and Review Services, and the Interpretations related to those Statements. It also includes the AICPA *Code of Professional Conduct*, AICPA Bylaws, Statement on Standards for Consulting Services, Statements on Quality Control Standards, Standards for Performing and Reporting on Peer Reviews and related Interpretations, Statements on Standards for Tax Services and related Interpretations, Statements on Standards in Personal Financial Planning Services, and Statement on Standards for CPE Programs and related Policies and Forms. Finally, the resource includes Statements of International Accounting Standards, Statements of International Standards on Auditing, and International Statements on Auditing.

(2) *Industry Audit and Accounting Guides.* These guides include recommendations for applying GAAP to financial statements of entities in specific industries and on applying certain audit methods to all financial statement audits.

(3) *Technical Questions and Answers.* This resource includes selected Technical Information Service Questions and Answers, Accounting Statements of Position, Audit and Attest Statements of Position, Practice Bulletins, Issues Papers of the Accounting Standards Division, and Practice Alerts.

(4) *AICPA Risk Alerts.* Although most small firms do not need all of the alerts, each firm needs the alerts that are applicable to its practice.

The preceding publications are available in bound or loose-leaf format and can be ordered by calling the AICPA Order Department at (888) 777-7077 or online at **www.aicpastore.com**. They are also available via online through Thomson Reuters by calling (800) 431-9025 or at the website **tax.thomsonreuters.com**, in conjunction with ownership of Thomson Reuters *Guides*.

b. *FASB Codification.* The *FASB Accounting Standards Codification* (FASB Codification) is the single source of authoritative U.S. generally accepted accounting principles (GAAP) to be applied by nongovernmental entities. The FASB Codification is available in two online versions (professional or basic). The basic online version is available at no charge and provides browsing by topic, basic print functionality, and utility to identify the location of the original standards. The professional online version, while not free, provides more extensive functionality and features. The FASB currently continues to provide bound volumes of certain pre-FASB Codification products, such as Original Pronouncements, Interpretations, and Technical Bulletins. The pre-FASB Codification products do not include authoritative guidance issued since the FASB codification became effective.

   The FASB Codification on Checkpoint is available as an add-on with a subscription to any PPC product on Checkpoint. The FASB Codification on Checkpoint provides enhanced functionality and advanced navigation related to the FASB Codification material and also accesses the complete library of prior statements, standards, and other supporting material. Contact Thomson Reuters at (800) 431-9025 or at the website **tax.thomsonreuters.com**.

   All of the FASB publications can be ordered from the FASB by calling their Order Department at (800) 748-0659 or via their website, **www.fasb.org**. Many of the pre-FASB Codification pronouncements are still available at no charge as originally issued on the FASB's website at **www.fasb.org**.

c. *Pronouncements of the Governmental Accounting Standards Board (GASB).* Similar to the FASB, the GASB is the primary standards-setting body for governmental accounting. Its pronouncements include Statements of the Governmental Accounting Standards Board, GASB Interpretations, GASB Technical Bulletins, consensus positions of the GASB Emerging Issues Task Force, and implementation guides prepared by the GASB's staff. Further information about GASB publications can be obtained by calling the GASB Order Department at (800) 748-0659 or online at **www.gasb.org**.

d. *Accounting and Auditing Manuals.* There are several sources that provide accounting and auditing manuals for local firms. Obviously, the authors prefer and recommend Thomson Reuters' PPC brand of manuals because they are interfaced with *PPC's Guide to Compilation and Review Engagements* (which is the basis for this course), are updated annually, and generally have been peer reviewed. For more information and a list of all accounting and auditing manuals available, visit Thomson Reuters' website at **tax.thomsonreuters.com** or call (800) 431-9025.

e. *Industry and Specialty Reference Sources.* Include in the firm library reference manuals that provide specialized guidance relating to the types of industries served by the firm.

Outside Firm Consultation. On particularly complex matters, outside consultation may be advisable. Some firms prepare a list of outside specialists that should normally be consulted when an accounting, SSARS, or tax issue is encountered. That party may be the technical arm of an association of firms, a specific CPA, or a tax lawyer that has a consulting relationship with the firm. In addition, the AICPA has a technical information service that answers inquiries on complex accounting, auditing, and SSARS issues. The toll-free number for this service is (888) 777-7077. The AICPA also has an Ethics hotline where members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other issues related to the application of the AICPA *Code of Professional Conduct*. The toll-free number for the Ethics Hotline is (888) 777-7077.

Differences of Opinion

QC 10 has requirements for dealing with and resolving differences of opinion as part of the engagement performance element.

Occasionally, differences of opinion concerning accounting issues may arise among—

- Firm personnel within the engagement team.
- The firm and individuals consulted.
- The engagement partner and the engagement quality control reviewer.

QC 10.46 states that firms should establish policies and procedures for dealing with and resolving differences of opinion. Those policies and procedures should require that (a) conclusions reached be documented and implemented, and (b) the report not be released until the difference of opinion is resolved.

If procedures are effective, they will encourage identification of differences of opinion at an early stage. They will also provide clear guidelines about the successive steps to be taken thereafter. In addition, procedures should require documentation regarding the resolution of the differences and the implementation of the conclusions reached. Procedures to resolve such differences may include consulting with another practitioner, firm, or professional or regulatory body.

Conclusions reached when dealing with differences of opinion should be documented. Specific guidance regarding this documentation is not provided in QC 10. The authors suggest that care be exercised in establishing policies and procedures for documenting differences of opinion. If the firm establishes documentation procedures that are too stringent, staff personnel may be discouraged from initiating general discussions of technical questions or issues for fear that these exchanges of ideas demand too much documentation time and effort.

The authors suggest that matters of a material nature be documented, while matters of a general nature or of minor technical importance should not require documentation. The decision of whether a question is of a general nature or of minor technical importance versus one that is material should be made by the engagement partner. Once the determination has been made that the issue is material, the firm should follow consistent documentation procedures.

Withdrawing from an Engagement or Ending a Client Relationship

When drafting policies and procedures for withdrawal from an engagement or a client relationship, QC 10.A16 explains that such policies and procedures may address issues that include the following:

- Discussing with the appropriate level of client management and those charged with governance appropriate actions that the firm might take.
- When the firm's decision is to withdraw, discussing that decision and the reasons for it with the appropriate level of client management and those charged with governance.
- Considering whether there are professional, regulatory, or legal requirements to (a) remain associated with the client and the engagement, or (b) report the withdrawal together with the reasons for it to regulatory authorities.
- Documenting significant matters, consultations, conclusions, and the basis for the conclusions.

SSARS literature requires an accountant to withdraw from a compilation or review engagement in the following circumstances:

- The accountant becomes aware that information supplied by the client is incorrect, incomplete, or otherwise unsatisfactory, and the client refuses to provide additional or revised information [AR-C 80.16 (AR-C 80A.16) and AR-C 90.A78 (AR-C 90A.A51)]. This includes not providing sufficient information to support the fact that financial statements are not materially misstated due to fraud, or that the entity is in

compliance with laws and regulations [AR-C 90.A78 (AR-C 90A.51)], in those instances where the accountant becomes aware that fraud may exist, or suspects noncompliance with laws and regulations.

- In a review, the accountant believes the written representations are unreliable or the client refuses to provide a representation letter, and the accountant decides (as would ordinarily be the case) that it is not appropriate to issue a compilation report [AR-C 90.63 (AR-C 90A.37)].
- A modification of the standard report will not adequately indicate the deficiencies in the financial statements taken as a whole [AR-C 80.32 (AR-C 80A.32) and (AR-C 90A.59)] After the implementation of SSARS No. 25, AR-C 90.53 clarifies that if management does not revise the financial statements for circumstances in which the accountant believes they need to be revised, the accountant should modify the accountant's review report or withdraw, as appropriate.

Documenting a Withdrawal. Any serious consideration to withdraw from an engagement would generally prompt significant discussion and major consultation among the partners of the firm. As previously discussed, QC 10 requires that major consultations be documented and filed in the engagement workpapers. Although the QC standard only suggests that policies and procedures for withdrawing from an engagement or client relationship include appropriate documentation, the authors believe that any decision to withdraw from an engagement would be subject to those same consultation documentation procedures.

Communicating the Decision to Withdraw or Discontinue Services. A decision to withdraw or discontinue services is a serious matter and, consequently, communication of this decision (especially to the client) should be carefully considered. The authors believe that, in most cases, the communication should be in writing. One option is to draft a resignation letter, which can be done using the form available in *PPC's Guide to Compilation and Review Engagements*. In some cases, the firm may need to contact legal counsel to determine the most appropriate method of making this communication.

Accounting and Engagement Issues Form. PPC has designed an "Accounting and Engagement Issues" form to provide standardized documentation of both in-firm and outside firm consultations. It provides a roadmap for documenting the resolution of a technical question or problem through consultation. If so desired, this form may also be used to document other significant findings or issues that do not require consultation. This form can be found in *PPC's Guide to Compilation and Review Engagements*.

SELF-STUDY QUIZ

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

19. Which of the following is a characteristic of a general ledger (G/L) software package?
    a. They allow transactions and journal entries to be entered when the user chooses.
    b. They can provide access for multiple businesses and clients.
    c. They are typically self-sufficient and cannot later be adjusted for add-on modules.
    d. They include predefined report layouts that can be adapted from a master library.
20. Which of the following tips will help accountants choose a write-up software package?
    a. Because the write-up package will be new, the system it is replacing does not need to be considered.
    b. Reporting software should be static, so accountants are comfortable that the reports will be correct.
    c. An important feature of such packages is quick and easy data entry.
    d. Software should be purchased rather than licensed for easier administration.
21. Accountants who have long-term relationships with their attest clients are most likely to face which of the following threats to independence?
    a. Advocacy threat.
    b. Familiarity threat.
    c. Management participation threat.
    d. Undue influence threat.
22. A practitioner's independence is impaired with respect to a client that it does any of the following **except:**
    a. Authorizing or executing transactions.
    b. Taking custody of client assets.
    c. Assisting management with the preparation of documents.
    d. Reporting to those charged with governance on management's behalf.
23. Which of the following statements best describes an issue related to consultations?
    a. Outside experts must be consulted for it to be officially considered a consultation.
    b. Looking at technical reference manuals is considered a consultation.
    c. Smaller firms are more likely to have in-firm consultations.
    d. Outside consultation is typically only needed for relatively simple issues.
24. A firm's policies and procedures about differences of opinion should ensure which of the following?
    a. That the reporting deadline is met even if the difference of opinion is not yet resolved.
    b. That differences of opinion are not identified until later in the engagement.
    c. That the conclusions reached are documented and implemented.
    d. That the documentation requirements are stringent and capture all the details.

SELF-STUDY ANSWERS

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

19. Which of the following is a characteristic of a general ledger (G/L) software package? **(Page 378)**

    a. **They allow transactions and journal entries to be entered when the user chooses. [This answer is correct. With a typical G/L package, transactions and journal entries can be entered when desired. After the entries for the period are entered, the period is closed (zeroed), and a new one is set up. Special routines are provided for closing the year-end and updating the retained earnings accounts. Transaction detail is normally lost after a year is closed.]**

    b. They can provide access for multiple businesses and clients. [This answer is incorrect. One characteristic of write-up packages is that they can handle multiple clients. Many G/L packages, on the other hand, are designed to handle only one business.]

    c. They are typically self-sufficient and cannot later be adjusted for add-on modules. [This answer is incorrect. Typically, for many G/L packages, users can buy add-on modules for major accounts and activities such as accounts receivable, accounts payable, inventory, and payroll. Although add-on modules are purchased separately, they link directly to the G/L. Consequently, transactions can be recorded in the G/L directly or through the subsidiary modules.]

    d. They include predefined report layouts that can be adapted from a master library. [This answer is incorrect. Report writers are where write-up packages (not G/L packages) shine. Predefined report layouts can be adapted from a master library or another client. Great flexibility is given to report headings, totaling, and account summarization. The packages are often designed to aid the accountant in producing GAAP financial accountant's reports and notes to the financial statements.]

20. Which of the following tips will help accountants choose a write-up software package? **(Page 379)**

    a. Because the write-up package will be new, the system it is replacing does not need to be considered. [This answer is incorrect. The current system, whether it is useful or useless, should be evaluated. Factors such as the number of current clients, the size of the practice, and the types of financial statements frequently generated (for example, special purpose framework vs. GAAP) should be considered.]

    b. Reporting software should be static, so accountants are comfortable that the reports will be correct. [This answer is incorrect. Periodically, the firm may need to make reporting changes to comply with various accounting standards. The accounting software package should provide the flexibility to make those changes. It is also beneficial if the accounting software allows the accountant to include note disclosures and produce the accountant's report.]

    c. **An important feature of such packages is quick and easy data entry. [This answer is correct. A significant portion of an accountant's time is often spent inputting data. Therefore, data entry should be easy and quick. When evaluating how easy a system is to use, some factors to consider include whether it is easy to (1) learn the system, (2) correct errors, and (3) set up new clients, and whether it has single keystroke options.]**

    d. Software should be purchased rather than licensed for easier administration. [This answer is incorrect. Software is usually *not* sold; it is licensed. Therefore, a firm should review the licensing agreements associated with various software packages.]

21. Accountants who have long-term relationships with their attest clients are most likely to face which of the following threats to independence? **(Page 383)**

    a. Advocacy threat. [This answer is incorrect. This is the threat that an accountant may lose independence by performing actions that promote an attest client's interests or position, such as representing a client in tax court.]

b. **Familiarity threat. [This answer is correct. Threats to independence are circumstances that could impair independence. Many different circumstances (or combinations of circumstances) can create threats to independence. The familiarity threat is most likely to arise when accountants have close or longstanding relationships with attest clients.]**

c. Management participation threat. [This answer is incorrect. This is the threat that performing management functions on behalf of an attest client, such as making hiring decisions, will affect an accountant's independence.]

d. Undue influence threat. [This answer is incorrect. This is the threat that an attest client's management will attempt to exercise influence over the accountant, such as pressure to reduce audit procedures for the purpose of reducing audit fees.]

22. A practitioner's independence is impaired with respect to a client that it does any of the following **except: (Page 385)**

a. Authorizing or executing transactions. [This answer is incorrect. According to ET 1.295.030.02, a practitioner's independence *is impaired* when exercising authority on behalf of a client, such as authorizing, executing, or consummating a transaction, or having the authority to do so.]

b. Taking custody of client assets. [This answer is incorrect. Having custody of client assets *impairs* a practitioner's independence per ET 1.295.030.02.]

c. **Assisting management with the preparation of documents. [This answer is correct. Per ET 1.295.030.02, preparing source documents, in electronic or other forms, that evidence the occurrence of a transaction would impair a practitioner's independence with respect to that client. Merely assisting which such preparation would *not* impair independence as long as all the requirements of ET 1.295 are met (e.g., management assumes all management responsibilities and evaluates the adequacy and results of the services performed.]**

d. Reporting to those charged with governance on management's behalf. [This answer is incorrect. Reporting to those charged with governance on behalf of management *impairs* a practitioner's independence with respect to that client, as outlined in ET 1.295.030.02.]

23. Which of the following statements best describes an issue related to consultations? **(Page 394)**

a. Outside experts must be consulted for it to be officially considered a consultation. [This answer is incorrect. Many practitioners tend to think of consultation only in terms of consultation with experts outside their firms. However, consultations include those both within and outside the firm.]

b. **Looking at technical reference manuals is considered a consultation. [This answer is correct. Consultation within the firm includes making use of the technical reference materials in the firm's library as well as seeing the personal expertise of other individuals within the firm.]**

c. Smaller firms are more likely to have in-firm consultations. [This answer is incorrect. The extent of specialization within a firm varies with firm size and individual firm preference. Naturally, the smaller a firm is, the less likely the firm has specialists available for consultation. Therefore, such firms would have to look outside when consultations are needed.]

d. Outside consultation is typically only needed for relatively simple issues. [This answer is incorrect. On particularly *complex* matters, outside consultation may be advisable. Some firms prepare a list of outside specialists that should normally be consulted when an accounting, SSARS, or tax issue is encountered.]

24. A firm's policies and procedures about differences of opinion should ensure which of the following? **(Page 396)**

a. That the reporting deadline is met even if the difference of opinion is not yet resolved. [This answer is incorrect. QC 10.46 states that a firm's policies and procedures about differences of opinion should require that the report *not* be released until the difference of opinion is resolved.]

b. That differences of opinion are not identified until later in the engagement. [This answer is incorrect. If procedures are effective, they will encourage identification of differences of opinion at an *early* stage of the engagement.]

c. **That the conclusions reached are documented and implemented. [This answer is correct. QC 10.46 states that firms should establish policies and procedures for dealing with and resolving differences of opinion. These policies and procedures should, among other things, require that conclusions reached be documented and implemented.]**

d. That the documentation requirements are stringent and capture all the details. [This answer is incorrect. Specific guidance for the documentation of differences of opinion is not provided in QC 10. This course suggests that care be exercised in establishing policies and procedures for documenting differences of opinion. If the firm establishes documentation procedures that are too stringent, staff personnel may be discouraged from initiating general discussions of technical questions or issues for fear that these exchanges of ideas demand too much documentation time and effort.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Compilation and Review Engagements—Course 3—Background Information and Engagement Administration for Compilation and Review Engagements (CARTG213)

Testing Instructions

1. Following these instructions is an **Examination for CPE Credit** consisting of multiple choice questions. 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 those 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 the PDF and can be printed if needed.

2. **ONLINE GRADING.** Log onto our Online Grading Center at **cl.tr.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $109 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

3. **PRINT GRADING.** If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($109 for email or fax; $119 for regular mail). The answer sheet is found at the end of the **Examination for CPE Credit**. Answer sheets may be printed from the PDF; they can also be scanned to send via email, if desired. Each answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for the course. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

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

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

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     CARTG213 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

   If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

4. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($109 for answer sheets sent by email or fax; $119 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three

courses, the price for grading all three is $310 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $392 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $463 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

5. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **July 31, 2022**. CPE credit will be given for examination scores of 70% or higher.

6. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** and the **Self-study Course Evaluation** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy of the answer sheet for your records.

7. Please direct any questions or comments to our Customer Service department at (800) 431-9025 (Option 2).

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Compilation and Review Engagements—Course 3—Background Information and Engagement Administration for Compilation and Review Engagements (CARTG213)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet is located at the end of the exam and can be printed out, if desired. Alternatively, it can be accessed by logging onto the Online Grading System.

1. Which of the following organizations is charged with serving the public interest by providing guidance to help accountants of nonissuers provide high quality, objective services under the Statements on Standards for Accounting and Review Services (SSARS) to their clients effectively and efficiently?

    a. The Accounting and Review Services Committee (ARSC).

    b. The American Institute of Certified Public Accountants (AICPA).

    c. The Financial Accounting Standards Board (FASB).

    d. The Public Company Accounting Oversight Board (PCAOB).

2. The scope of the ARSC's authority is limited to which of the following?

    a. Audited financial statements and audited financial information of nonissuers.

    b. Audited and reviewed financial statements of issuers.

    c. Unaudited financial statements and other unaudited financial information of nonpublic entities.

    d. Audited and unaudited financial statements of nonpublic entities that use generally accepted accounting principles.

3. How many of the SSARS are codified into AR-C Sections AR-C 60, 60A, 70, 70A, 80, 80A, 90, 90A, 100, and 120?

    a. SSARS Nos. 1–20.

    b. SSARS Nos. 1–25.

    c. SSARS Nos. 15–25.

    d. SSARS Nos. 21–25.

4. What guidance provides the overall framework for conducting a SSARS engagement?

    a. AR-C 60A.

    b. AR-C 70A.

    c. AR-C 80A.

    d. AR-C 90A.

5. Unconditional requirements are introduced by what word?

    a. Might.

    b. Must.

    c. Should.

    d. Will.

6. Which of the following amendments did SSARS No. 24 make to AR-C 90A?

   a. It added a paragraph stating that an accountant's independence is impaired by accepting responsibility for the design, implementation, and maintenance of internal control.

   b. It requires accountants to reference reports from other accountants in the review report, even if that report is restricted in use.

   c. It requires accountants to include an emphasis-of-matter paragraph in review reports if there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time even after considering conditions, events, and management's plans.

   d. It eliminates the responsibility of ensuring that other accountants understand the ethical requirements pertaining to the engagement, including independence requirements, from the accountant of the reporting entity.

7. An accountant engaged to prepare financial statements under AR-C 70 (AR-C 70A) is required to do which of the following?

   a. Establish an oral understanding with the client about the services to be performed.

   b. Prepare the financial statements in accordance with generally accepted accounting principles (GAAP).

   c. Include a legend on each page stating that the accountant does not provide assurance on the financial statements.

   d. Take responsibility for any significant judgments regarding disclosures or amounts reflected in the financial statements.

8. Which of the following statements correctly describes a financial preparation engagement performed under the SSARS?

   a. If an accountant lacks experience or knowledge about a particular industry, they are prohibited from accepting the engagement.

   b. The only information that the accountant will need from management is records and documents about specific transactions.

   c. If management requests that the accountant prepare financial statements with departures from the financial reporting framework, the accountant must withdraw.

   d. The accountant must prepare documentation with sufficient detail to provide a clear understanding of the work performed.

9. Where can accountants find guidance for performing a compilation or review engagement on financial statements prepared using a financial reporting framework from another country?

   a. AR-C 70.

   b. AR-C 80.

   c. AR-C 90.

   d. AR-C 100.

10. Which of the following principles should be kept in mind when performing a SSARS engagement?

    a. The SSARS impose certain responsibilities on management that must be fulfilled over the course of the engagement.

    b. If a SSARS requirement conflicts with laws and regulations, the SSARS should be followed.

    c. The exercise of professional judgment is critical to the successful performance of a SSARS engagement.

    d. The ethical requirements for a SSARS engagement are different from those outlined in the AICPA's *Code of Professional Conduct* (the Code).

11. Considerations related to the acceptance and continuance of SSARS engagements—

    a. are completed before fieldwork begins.

    b. occur throughout the engagement.

    c. are irrevocable once documented.

    d. will not lead to withdrawal after the engagement commences.

12. Can an accountant accept a SSARS engagement if issues are encountered when performing client acceptance and continuance procedures?

    a. Yes, the accountant can accept the engagement with no further action required.

    b. Yes, if the resolution of the issues is documented, the accountant can still accept the engagement.

    c. Yes, as long as the issues were not related to the availability or reliability of information, the accountant can accept the engagement.

    d. No, the accountant cannot accept the engagement without being in violation of both legal and ethical requirements.

13. When would financial presentations included in tax returns be considered financial statements under the SSARS?

    a. Always—any financial presentation of this type is considered financial statements under the SSARS.

    b. Sometimes—if the tax return is subsequently used for a purpose other than submission to a taxing authority.

    c. Never—the SSARS specifically exempt this type of financial presentation from their coverage.

    d. Never—accountants are prohibited from performing compilations or reviews on this type of financial information.

14. The SSARS are considered to be *engagement driven*. What does this mean?

    a. They do not apply unless the accountant is specifically engaged by the client.

    b. They do not apply unless the accountant actually provides the client with financial statements.

    c. They apply only if the accountant assists management in preparing financial statements.

    d. They apply only if the client is considered to be a public entity.

15. North Star Inc. engages an accountant to provide financial information management needs to make business decisions. Monthly compiled GAAP financial statements will be too costly. Management decides that monthly reports including summarized financial and operational information will suffice. Do the SSARS apply to this engagement?

    a. Yes, the SSARS will apply to each monthly engagement.

    b. No, the SSARS do not apply to any of the monthly engagements.

    c. No, the SSARS will not apply unless the financial information is considered a financial statement.

    d. No, the SSARS will not apply unless the financial information is considered a trial balance.

16. According to AR-C 70.10 (AR-C 70A.10), the agreement upon the terms of a SSARS engagement—

    a. is required to be documented in an engagement letter.

    b. should be documented in an engagement letter or another suitable written form.

    c. can be documented in writing or determined during an oral discussion with the client.

    d. is required to be documented in the workpapers after an oral discussion with the client.

17. Who should sign an engagement letter for a SSARS engagement?

    a. Both the accountant and the client.

    b. Only the accountant or the accountant's firm.

    c. Only the client's management or those charged with governance.

    d. The requirements under SSARS are the same as those for an audit.

18. Including which of the following in an engagement letter could help accountants defend against malpractice and breach of contract claims from a client?

    a. A clause requesting alternative dispute resolution (ADR).

    b. Informing clients about outsourcing arrangements.

    c. Specifying a time limitation on legal claims.

    d. An undertaking-to-be-truthful clause.

19. Under what circumstances should an accountant withdraw from an engagement when the client requests a step-down in level from the audit or review already in progress?

    a. Management does not provide the representations required for the higher-level engagement.

    b. The requirement for the audit or review is removed after the engagement begins (i.e., negotiations collapse).

    c. The client misunderstood the nature of the higher-level engagement already in progress.

    d. The client requests a financial statement preparation engagement instead of the engagement already begun.

20. When considering subsequent events, the *subsequent period* covers what amount of time?

    a. From the time fieldwork begins until fieldwork is completed on the engagement.

    b. From the beginning of the engagement through the conclusion of the engagement.

    c. From the balance sheet date through when management issues the financial statements.

    d. From the date when management issues the financial statements to the commencement of the next annual engagement.

21. What guidance applies when accountants subsequently discover facts that existed at the date of the compilation or review report that would have made them believe information supplied by the client was incorrect, incomplete, or otherwise unsatisfactory?

    a. If the report has already been issued, accountants are not required to investigate such information.

    b. If the report has already been issued, clients are under no obligation to disclose the new facts until their next annual SSARS engagement.

    c. Clients may need to issue revised financial statements or disclose the revision in subsequent financial statements, depending upon the circumstances.

    d. Accountants are not required to notify anyone about the information or requested disclosures other than management.

22. At a minimum, the workpapers for a financial statement preparation engagement should include what?

    a. An engagement letter and financial statements.

    b. Financial statements and an accountant's report.

    c. An engagement letter, financial statements, and an accountant's report.

    d. An engagement letter, financial statements, and various communications with management.

23. What authoritative guidance determines how long workpapers and other documentation are retained for a compilation or review engagement?

    a. SSARS.

    b. QC 10.

    c. ET 1.295.

    d. FASB ASC 855.

24. In what type of engagement is a successor accountant required to communicate with the predecessor accountant?

    a. Audits.

    b. Compilations.

    c. Financial statement preparations.

    d. Reviews.

25. Limiting the types of clients accepted by the firm, making sure to stay within the scope of each engagement, and applying professional skepticism are examples of which of the following?

    a. Damage control.

    b. Firm structure.

    c. Quality control.

    d. Risk avoidance.

26. Ordinarily, how many licenses is a sole practitioner required to have?

    a. One.

    b. Two.

    c. Three.

    d. Four.

27. What is the purpose of a firm's quality control system?

    a. To promote quality in accounting and auditing engagements.

    b. To eliminate the threat of litigation against CPA firms.

    c. To provide absolute assurance on engagement performance.

    d. To help the AICPA and state societies regulate CPA firms.

28. How do the Statements on Quality Control Standards (SQCSs) relate to the SSARS?

    a. Guidance in the SSARS takes precedence over guidance in the SQCSs.

    b. Guidance in the SQCSs takes precedence over guidance in the SSARS.

    c. Guidance in the SQCSs applies to the firm as a whole, while guidance in the SSARS applies to the performance of individual engagements.

    d. Guidance in the SSARS applies to the firm as a whole, while guidance in the SQCSs applies to the performance of individual engagements.

29. According to AR-C 60.21a (AR-C 60A.21a), who is responsible for the overall quality of the SSARS engagement to which they are assigned?

    a. The engagement partner.

    b. The entire engagement team.

    c. Those charged with governance.

    d. The client's management.

30. The CPA firm of Harvard & Booker performs bookkeeping and other nonattest services, as well as SSARS engagements (compilations, reviews, financial statement preparations, etc.). What type of peer review will this firm need to have every three years?

    a. An engagement review.

    b. A system review.

    c. An engagement review, but it can elect to have a system review.

    d. A system review, but it can elect to have an engagement review.

31. Accounting software—

    a. is seldom used in compilation and review engagements.

    b. has a limited selection for accountants to choose from.

    c. records receipts and disbursements and generates financial statements.

    d. cannot produce tax information in an official IRS format.

32. Integrated accounting programs, including those that are linked with other modules to create comprehensive accounting systems, are generally considered what?

    a. Computer systems.

    b. General ledger (G/L) packages.

    c. Report writers.

    d. Write-up packages.

33. Which of the following is characteristic of a typical write-up software package?

    a. Clients' data files can be directly imported into the software.

    b. A chart of accounts is developed by assigning numbers and descriptions.

    c. They have limited abilities for the detail and formatting of reports without extra add-ons.

    d. Data entry is typically limited to the original functionality of the program without modifications.

34. What type of software review is likely to be the least biased?

    a. Comparison reviews.

    b. Single product reviews.

    c. Reviews from a sales representative.

    d. Information from the software developer support line.

35. Controls that mitigate or eliminate threats to independence are called what?

    a. A conceptual framework.

    b. A code of professional conduct.

    c. Policies and procedures.

    d. Safeguards.

36. Joanna, a CPA, is engaged to prepare her client's tax return. The client then wants her to transmit the tax return, along with the related payment, electronically to the taxing authority. Can Joanna retain her independence from her client in this situation?

    a. No, by performing this engagement, Joanna's independence will be impaired with respect to this client.

    b. Yes, as long as Joanna never takes custody of the client's assets, she will retain her independence from this client.

    c. Yes, Joanna can retain independence as long as she does not take custody of assets and someone from the client takes on certain responsibilities.

    d. Yes, performing this engagement causes no issues related to Joanna's independence in relation to this client.

37. Assuming all the requirements of ET 1.295 are met, accountants can perform which of the following services and retain their independence?

    a. Proposing journal entries and other bookkeeping tasks.

    b. Performing material appraisal, valuation, or actuarial services.

    c. Providing expert witness testimony for a single client.

    d. Performing multiple nonattest services without relevant safeguards.

38. Would being the sole host of a client's nonfinancial information system impair a CPA's independence?

    a. No, providing this type of hosting service will not impair independence per ET 1.295.143, *Hosting Services*.

    b. No, providing this type of hosting service is considered part of an attest engagement and will not impair independence.

    c. No, hosting a nonfinancial information will not impair independence, but hosting a financial information system will.

    d. Yes, hosting a nonfinancial information system is a nonattest service and will impair independence from an attest client.

39. Are consultations required for SSARS engagements?

    a. Yes, the SSARS require that all engagements include a consultation.

    b. Yes, if a technical issue arises, the SSASRS require accountants to resolve it using a consultation.

    c. No, accountants can obtain the level of knowledge required by SSARS via consultations or other methods.

    d. No, the SSARS prohibit the use of consultations in compilations and reviews.

40. A resignation letter is typically used to do which of the following?

    a. Request an outside-firm consultation over a technical issue.

    b. Resolve differences of opinion between the firm and the client.

    c. Document the decision to withdraw from an engagement.

    d. Communicate the decision to withdraw from an engagement.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Compilation and Review Engagements—Course 3—Background Information and Engagement Administration for Compilation and Review Engagements (CARTG213)

Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State/ZIP: _____

Firm Phone: _____ Firm Fax No.: _____

Firm Email: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answers for each question by filling in the appropriate circle as shown: Fill in like this: ● not like this: Ⓘ ⊗ ✓

You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Expiration Date: July 31, 2022

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Compilation and Review Engagements—Course 3—Background Information and Engagement Administration for Compilation and Review Engagements (CARTG213)

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. How would you rate the appropriateness of the course materials for your experience level?	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course content?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant, and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. _____

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can. (Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of this page. **Yes/No** ○ ○

For more information on our CPE & Training solutions, visit cl.tr.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____.

GLOSSARY

Accounting and auditing practice: According to the Peer Review Standards, this consists of all engagements performed under the SASs, SSARS (excluding those engagements for which SSARS has provided an exemption), SSAEs, *Government Auditing Standards* (the Yellow Book) issued by the GAO, and the PCAOB standards. The QC standards define this as a practice that performs audit, attestation, compilation, review, and any other services for which standards have been promulgated by the ASB or ARSC under the *General Standards Rule*, of the Code.

Accounting and Review Services Committee (ARSC): A senior technical committee of the American Institute of Certified Public Accountants (AICPA) with a mission to serve the public interest by developing, updating, and communicating comprehensive standards and practice guidance that enables accountants of nonissuers to provide high quality, objective SSARS services to nonissuers effectively and efficiently.

AICPA *Code of Professional Conduct* (the Code): This sets forth the fundamental principles of professional ethics that should be followed in a SSARS engagement, including those related to integrity, objectivity, and due care. It applies to all individuals who are members of the AICPA. It has also been adopted (all or in part) into the rules of conduct of certain state CPA societies and state boards of accountancy.

Alternative dispute resolution (ADR): Ways to attempt to resolve client disputes without exposing the firm to the cost and uncertainty of litigation. ADR may take less time and have a better chance of preserving the relationship with the client. Popular ADR methods include arbitration and mediation.

Attest engagement: An engagement that requires independence under the Code. This includes audits, examinations, agreed-upon procedures engagements, reviews, and compilations.

Comparative financial statements: The current financial statements are presented in comparative form with prior period financial statements to enhance their usefulness.

Confidential client information: This is information that is not available to the public, per the Code. Information considered to be in the public domain or available to the public would not be included as part of this term.

Damage control: Procedures that focus on responding quickly to threatened and actual liability claims and designating a response team to manage the internal process.

Engagement partner: The partner or other person in the firm who is responsible for the engagement and its performance and for the report that is issued on behalf of the firm and who, when required, has the appropriate authority from a professional, legal, or regulatory body.

Engagement quality control review (EQCR): Firms establish criteria as part of their quality control policies and procedures to determine when this type of review should be performed. No EQCRs need to be performed if no engagements meet the established criteria.

Presumptively mandatory requirements: Requirements with which accountants are required to comply in all cases in which the circumstances exist to which the requirement applies. However, accountants may depart from such a requirement if they justify the departure and how alternative procedure(s) performed in the circumstances were sufficient to achieve the objectives of the requirement. They are introduced by the word *should*.

Public practice: The practice of public accounting; providing services to a client.

Quality control materials (QCM): A firm's engagement work programs, checklists, sample confirmations and letters, and other practice aids that help ensure compliance with both authoritative literature and peer review standards. These are an integral part of a firm's quality control system.

Safeguards: Controls that mitigate or eliminate threats to independence. To be effective, they must eliminate the threat or reduce the threat's potential to impair independence to an acceptable level. Some are created by the profession, legislation, or regulation. Some are implemented by the attest client. Some are implemented by the firm.

Step-down: Changing to a lower level of service after the engagement has begun. A step-down may be requested for three reasons: (1) a change in circumstances affecting the entity's requirement for an audit or review; (2) a misunderstanding as to the nature of an audit or review, or the alternative review and compilation services originally available; or (3) a restriction on the scope of the audit or review, whether imposed by the client or caused by circumstances. The propriety of a step-down must be considered before the practitioner agrees, and relevant guidance must be followed.

Step-up: Changing to a higher level of service after the engagement has begun. As long as the engagement is completed according to the standards, a step-up poses no danger to the practitioner.

Subsequent period: The period between the balance sheet date and management's issuance of the financial statements.

Trial balance: Practitioners may provide a trial balance in the course of providing accounting services to a client. This is different from preparing financial statements, as the provisions of SSARS do not apply. Trial balances do not group general ledger accounts to create single line items; include totals and subtotals, such as current assets and total assets; or net contra accounts against primary accounts. Trial balances include the term *trial balance* in their title and present accounts based on the account numbers. The only mathematical relationship in trial balances is total debits equal total credits. They do not reflect the results of operations, and retained earnings is the balance as of the beginning of the period.

Type I subsequent events: These consist of events that provide additional evidence about conditions that existed at the balance sheet date and that affect the estimates inherent in preparing the financial statements. The proper accounting treatment is adjustment of the financial statements. They are also called *recognized subsequent events*.

Type II subsequent events: These consist of events that did not exist at the balance sheet date but that arose after the balance sheet date but before the financial statements are issued or are available to be issued. Some may require disclosure to keep the financial statements from being misleading. They are also called *nonrecognized subsequent events*.

Unaudited: In practice, this refers to the (1) prepared financial statements of a nonpublic entity, (2) compiled financial statements of a nonpublic entity, (3) reviewed annual financial statements of a nonpublic entity, and (4) reviewed interim financial statements of a nonpublic entity.

Unconditional requirements: Requirements with which accountants are required to comply in all cases in which the circumstances exist to which the requirement applies. They are introduced by the word *must*.

Undertaking-to-be-truthful clause: A clause in an engagement letter indicating an agreement by the client to be truthful, accurate, and complete in making representations to the firm. It can help limit a firm's legal liability.

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