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Companion to PPC's Guide to

Cash, Tax, and Other Bases of Accounting

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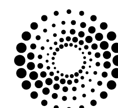

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Interactive Self-study CPE

Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting

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INTRODUCTION

Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting consists of two interactive self-study CPE courses. These are companion courses to *PPC's Guide to Cash, Tax, and Other Bases of Accounting* designed by our editors to enhance your understanding of the latest issues in the field. *PPC's Guide to Cash, Tax, and Other Bases of Accounting* 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 **October 31, 2023**. Complete instructions for grading are included below and in the test instructions preceding the **Examination for CPE Credit**.

Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of financial statements prepared using a special purpose framework. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the 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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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 are listed on the **Overview** page before each course.

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

Obtaining CPE Credit

Online Grading. Log onto our Online Grading Center at **cl.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 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 CASH, TAX, AND OTHER BASES OF ACCOUNTING

COURSE 1

SPECIAL PURPOSE FINANCIAL STATEMENTS AND RELATED ENGAGEMENT CONSIDERATIONS (OFSTG221)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses issues related to special purpose financial statements. Lesson 1 provides a basic introduction to special purpose financial statements, including background information, how to decide when to use them, and issues related to preparing them. Lesson 2 takes a more in-depth look at special purpose framework engagement considerations such as independence, compilation and review procedures, and engagement letters.
PUBLICATION/ REVISION DATE:	October 2022
RECOMMENDED FOR:	Users of *PPC's Guide to Cash, Tax, and Other Bases of Accounting*
PREREQUISITE/ ADVANCE PREPARATION:	Basic knowledge of accounting
CPE CREDIT:	8 NASBA Registry "QAS Self-Study" Hours This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.
FIELD OF STUDY:	Accounting
EXPIRATION DATE:	Postmark by **October 31, 2023**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—An Introduction to Special Purpose Financial Statements

Completion of this lesson will enable you to:

- Identify basic information about special purpose financial statements, including relevant authoritative literature and recent GAAS and SSARS developments that may apply.
- Determine when to use a special purpose framework and how to address a few of the primary issues related to preparing special purpose financial statements.

Lesson 2—Special Purpose Framework Engagement Considerations

Completion of this lesson will enable you to:

- Recognize how the quality control and peer review standards and the independence rules of the AICPA *Code of Professional Conduct* apply to special purpose framework engagements.
- Identify the compilation and review procedures that apply to special purpose framework engagements.
- Determine how engagement letters and management representation letters are treated in this type of engagement.

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
OFSTG221 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: An Introduction to Special Purpose Financial Statements

INTRODUCTION

This lesson provides an introduction to special purpose financial statements that will help prepare practitioners to perform the special purpose framework engagements discussed in Lesson 2.

Lesson 1 begins with some background and other basic information about special purpose financial statements. Then it takes a look at the authoritative literature that applies to such engagements, including a discussion of recent GAAS and SSARS developments.

Next, this lesson provides more practical engagement-related information. It discusses how to determine when a special purpose framework should be used to prepare an entity's financial statements. Finally, this lesson concludes with a brief discussion of the primary issues faced when preparing such financial statements.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify basic information about special purpose financial statements, including relevant authoritative literature and recent GAAS and SSARS developments that may apply.
- Determine when to use a special purpose framework and how to address a few of the primary issues related to preparing special purpose financial statements.

BACKGROUND AND OTHER BASIC INFORMATION ABOUT SPECIAL PURPOSE FINANCIAL STATEMENTS

Bases of accounting other than GAAP, which are primarily referred to in the authoritative literature as *special purpose frameworks*, are a widely used alternative to the numerous and sometimes complex accounting requirements prescribed by generally accepted accounting principles (GAAP). Also contributing to the use of non-GAAP financial reporting is the availability of inexpensive accounting software, which allows individuals more familiar with tax laws than GAAP to maintain records and prepare financial statements with relative ease. (Because special purpose framework financial statements should include disclosures similar to those required by GAAP when the financial statements contain items that are the same as or similar to GAAP, the authors believe accountants should not accept an engagement to prepare such financial statements unless they have a good foundation in generally accepted accounting principles.) Compared to the voluminous amount of GAAP basis guidance available, limited authoritative guidance exists for using special purpose frameworks, and the guidance that does exists is found in the pronouncements of the AICPA. The use of special purpose frameworks is not addressed in the *FASB Accounting Standards Codification*.

The use of special purpose frameworks is discussed in the auditing standards and the SSARS. AU-C 210A, *Terms of Engagement*, requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements. Ordinarily, that framework is provided by GAAP; but AU-C 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, and the SSARS allow the use of special purpose frameworks, which are described as—

- *Cash Basis.* A basis of accounting used by the reporting entity to record cash receipts and disbursements. It includes modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets), commonly known as the *modified cash basis*.
- *Tax Basis.* A basis of accounting the reporting entity uses to file its tax return for the period covered by the financial statements. (The term *income tax basis* is also commonly used and both terms can be found in

this course. While *tax basis* and *income tax basis* mean the same thing, the authors recommend that firms select whichever term is preferred and use it consistently in order to avoid confusion.)

- *Regulatory Basis.* A basis of accounting used by the reporting entity to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance commission).
- *Contractual Basis.* A basis of accounting used by the entity to comply with an agreement between the entity and one or more third parties other than the practitioner.
- *Other Basis.* A basis of accounting utilizing a definite set of logical and reasonable criteria that is applied to all material items within the financial statements.

This course uses the term *special purpose framework*. However, according to the auditing standards and the SSARS, the cash, tax, regulatory, and other bases of accounting are also commonly referred to as *other comprehensive bases of accounting* (or OCBOAs).

As previously mentioned, practitioners who are involved with financial statements that are prepared using a special purpose framework still need to be familiar with GAAP requirements. When special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, the auditing standards and the SSARS require that the financial statements should include informative disclosures similar to those required by GAAP. Further, additional disclosures beyond those specifically required by the framework related to matters that are not specifically identified on the face of the financial statements, or other disclosures, might be necessary for the financial statements to achieve fair presentation. Information on the authoritative literature that accountants and auditors should follow, recent changes in the authoritative literature, and how those changes have been incorporated in this course is provided later in this lesson.

Addressing Accounting Standards Overload

On and off for decades, the AICPA has examined the issue of standards overload. A solution that has often been mentioned is the use of financial statements prepared under a financial reporting framework other than GAAP. One of the earliest studies was performed by the AICPA in 1981. Almost a decade and a half later, in 1995, the AICPA appointed the Special Task Force on Standards Overload, which eventually resulted in the Auditing Standards Board issuing Interpretation 14 of AU 623.

In 2004, a task force of the AICPA conducted a survey that found that certain types of financial statement users were more likely to accept non-GAAP financial statements for privately-held, for-profit companies. The survey also found that the size of the reporting company was a factor in the decision to accept financial statements prepared under a financial reporting framework other than GAAP for the majority of the financial statement users that accepted them. The task force concluded that GAAP should specifically address the needs of private company financial statement users. As a result of those findings, the AICPA and FASB began working together to explore the development of accounting standards for privately held companies. In 2006, the two organizations issued a joint proposal intended to improve the financial reporting process for private companies, and in 2007, the Private Company Financial Reporting Committee (PCFRC) began making recommendations regarding accounting standards proposals to the FASB. However, while the PCFRC was still operating, the AICPA and the Financial Accounting Foundation (FAF) held a series of meetings that resulted in the decision to create a new board to be overseen by the FAF that would focus on making exceptions and modifications to U.S. GAAP for private companies that better responded to the needs of the private company sector. Thus, the PCFRC ceased to exist as of December 31, 2012, after it was replaced by the Private Company Council.

Private Company Council. The Private Company Council (PCC) was established to improve the process of establishing accounting standards for private companies. The responsibilities of the PCC are two-fold:

a. To advise the FASB on the appropriate accounting treatment for private companies for items currently being addressed by the FASB.

b. To advise the FASB on possible GAAP alternatives to address the needs of users of the financial statements of private companies.

The authors believe it is important to note that while groups formed in the past have had similar purposes, the PCC directly influences GAAP for private companies. As such, private companies are afforded certain exceptions and/or modifications within the existing body of GAAP. Additional information about the PCC, its projects, and its relationship with the FASB may be found at **www.fasb.org/info/pcc**.

AICPA Financial Reporting Framework for Small- and Medium-sized Entities. The AICPA's *Financial Reporting Framework for Small- and Medium-Sized Entities* (FRF for SMEs™) is an optional reporting framework, which provides another GAAP-alternative for small businesses. However, unlike the other common GAAP-alternative frameworks, the FRF for SMEs accounts for an entity's transactions according to their economic substance, which is the same objective as GAAP. While historical cost is the primary measurement basis, there are also some similarities to the accrual income tax basis. For certain accounting policies, the FRF for SMEs allows alternatives so that an individual business can select the policy they believe best meets the needs of the users of their financial statements. In short, the FRF for SMEs provides greater reporting flexibility than GAAP.

The FRF for SMEs is not authoritative, so it has not been acted upon, approved, or disapproved by any senior technical committee of the AICPA or FASB. It has no effective date and the AICPA cannot require its use. Small- and medium-sized entities can choose to adopt it at any time. Practitioners can report on compiled, reviewed, or audited financial statements prepared using FRF for SMEs because it meets the definition of a special purpose framework, as described earlier in this lesson, in the *other basis* category.

Additional Information. The AICPA provides a free PDF of the FRF for SMEs available for download, a list of frequently asked questions and answers, three different FRF for SMEs toolkits, and more, all at **www.aicpa.org/FRF-SMEs**.

Thomson Reuters publishes *PPC's Guide to the Financial Reporting Framework for Small- and Medium-Sized Entities*. The publication provides detailed guidance on preparing financial statements based on the FRF for SMEs, including illustrations and other tools to assist in converting GAAP-basis financial statements to the FRF for SMEs, and to help accountants explain the FRF for SMEs to clients and financial statement users. Visit the website at **tax.thomsonreuters.com** for additional information about the *Guide* or to purchase.

AUTHORITATIVE LITERATURE THAT APPLIES TO SPECIAL PURPOSE FINANCIAL STATEMENTS

FASB Accounting Standards Codification (GAAP)

Practitioners involved with financial statements prepared using a special purpose framework need to be familiar with GAAP requirements because generally accepted auditing standards and the SSARS require that when special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, those financial statements should include informative disclosures similar to those required by GAAP. GAAP measurement and disclosure requirements can be found in the *FASB Accounting Standards Codification*. The *FASB Accounting Standards Codification* (FASB ASC) is the single source of authoritative nongovernmental U.S. generally accepted accounting principles (GAAP). Other accounting literature not included in the FASB ASC is nonauthoritative.

Generally Accepted Auditing Standards (GAAS)

Auditing Standards and Special Purpose Framework Engagements. AU-C 800 provides guidance for auditing special purpose financial statements. Some of the items in AU-C 800 that affect special purpose framework audit engagements include:

- *Terminology.* The auditing standards have generally replaced the term *other comprehensive basis of accounting* with the term *special purpose framework*.

- *Acceptability of the Reporting Framework.* The auditor is required to determine whether the special purpose framework used to prepare the entity's financial statements is acceptable by obtaining an understanding of (a) the purpose for which the financial statements are prepared, (b) the intended users, and (c) the steps taken by management to determine that the framework is acceptable in the circumstances.
- *Preconditions for the Audit.* The auditor is required to obtain management's agreement that it acknowledges and understands its responsibility to include all informative disclosures that are appropriate for the special purpose framework used to prepare the financial statements. Management's acknowledgment and understanding should also cover any additional disclosures necessary to achieve fair presentation in the financial statements. The auditor should evaluate whether such disclosures are necessary.
- *Regulatory and Contractual Bases.* When the special purpose framework is the regulatory or contractual basis, certain performance, reporting, and/or presentation requirements exist.
- *Reporting.* Reporting requirements exist that affect all types of special purpose frameworks.

Exhibit 1-1 provides a listing of the auditing standard requirements of AU-C 800 for special purpose framework financial statements.

Exhibit 1-1

Audits of Financial Statements Prepared Using a Special Purpose Framework

Requirements/Guidance	AU-C Reference
Definitions:	
Special purpose framework—a financial reporting framework other than GAAP that is one of the following bases of accounting—	AU-C 800.07
• *Cash basis*—A basis of accounting that the entity uses to record cash receipts and disbursements, including modifications of the cash basis having substantial support.	AU-C 800.07a
• *Tax basis*—A basis of accounting an entity uses to file its income tax return for the period covered by the financial statements.	AU-C 800.07b
• *Regulatory basis*—A basis of accounting an entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject.	AU-C 800.07c
• *Contractual basis*—A basis of accounting an entity uses to comply with an agreement between the entity and one or more third parties other than the auditor.	AU-C 800.07d
• *Other basis*—A basis of accounting that uses a definite set of logical and reasonable criteria that is applied to all material items in the financial statements.	AU-C 800.07e
Use of the term *financial statements* in AU-C 800 means a complete set of special purpose financial statements. The requirements of the applicable financial reporting framework determine the presentation, structure, and content of the financial statements and what constitutes a complete set of financial statements.	AU-C 800.08
Requirements:	
Considerations When Accepting the Engagement	
AU-C 210A, *Terms of Engagement*, requires the auditor to determine whether the financial reporting framework used in the preparation of the financial statements is acceptable. For an audit of special purpose financial statements, the auditor should obtain an understanding of— • the purpose for which the financial statements are prepared,	AU-C 800.10

Requirements/Guidance	AU-C Reference
• the intended users, and • the steps taken by management to determine that the financial reporting framework used is acceptable in the circumstances.	
AU-C 210A requires the auditor to determine whether the preconditions for an audit are present, including whether the financial reporting framework used for the preparation of the financial statements is acceptable. When auditing special purpose financial statements, the auditor should obtain management's agreement that it acknowledges and understands its responsibility to include all informative disclosures that are appropriate for the special purpose framework used to prepare the entity's financial statements. This includes—	AU-C 800.11
• A description of the special purpose framework, including a summary of significant accounting policies, and how the framework differs from GAAP, the effects of which need not be quantified.	AU-C 800.11a
• Informative disclosures similar to those required by GAAP, when the special purpose financial statements contain matters that are the same as, or similar to, financial statements prepared in accordance with GAAP.	AU-C 800.11b
• A description of any significant interpretations of the contract on which the special purpose financial statements are based, when the special purpose financial statements are prepared in accordance with a contractual basis of accounting.	AU-C 800.11c
• Additional disclosures beyond those specifically required by the framework that may be necessary for the special purpose financial statements to achieve fair presentation.	AU-C 800.11d
Considerations When Planning and Performing the Audit	
AU-C 200, *Overall Objective of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, requires the auditor to comply with all AU-C sections pertinent to the audit. Accordingly, in planning and performing an audit of special purpose financial statements, the auditor should adapt and apply as necessary all AU-C sections relevant to the circumstances of the audit engagement.	AU-C 800.12
AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires the auditor to obtain an understanding of the entity's selection and application of accounting policies. When the contractual basis of accounting is used to prepare the financial statements, the auditor should obtain an understanding of any significant interpretations of the contract that management made in the preparation of those financial statements.	AU-C 800.13
Forming an Opinion and Reporting Considerations	
Whether or not the going concern basis of accounting applies to the special purpose financial statements, the auditor should perform the following tasks, as required by AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*:	AU-C 800.14
• Conclude as to whether there are conditions or events in the aggregate that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.	AU-C 800.14a
• When such substantial doubt exists, evaluate whether the financial statement disclosures are adequate.	AU-C 800.14b

Requirements/Guidance	AU-C Reference
When forming an opinion and reporting on special purpose financial statements, the auditor should apply the requirements of AU-C 700, *Forming an Opinion and Reporting on Financial Statements*, and AU-C 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*. When, in forming an opinion, the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary, the auditor should apply the requirements of AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*.	AU-C 800.15
AU-C 700 requires the auditor to evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework. For special purpose financial statements, the auditor should evaluate whether the financial statements are suitably titled, include a summary of significant accounting policies, and adequately describe how the framework differs from GAAP. (The effects of differences need not be quantified.)	AU-C 800.16
When the financial statements are prepared in accordance with a contractual basis of accounting, the auditor should also evaluate whether the financial statements adequately describe any significant interpretations of the contract affecting the financial statements. (Significant interpretations are those for which another reasonable interpretation would produce a material difference in the financial statements.)	AU-C 800.17
AU-C 700 requires the auditor to evaluate whether the financial statements are fairly presented. When the audited special purpose financial statements contain items that are the same as, or similar to, those in GAAP financial statements, the auditor should evaluate whether the special purpose financial statements include informative disclosures similar to those required by GAAP. Additionally, the auditor should evaluate whether disclosures, beyond those specifically required by the framework, related to matters that are not identified on the face of the financial statements or other disclosures are necessary for the financial statements to be fairly presented.	AU-C 800.18
AU-C 700 addresses the form and content of the auditor's report, including the specific ordering for certain elements. In the case of an auditor's report on special purpose financial statements—	AU-C 800.19
• The report should describe the purpose for which the financial statements are prepared or refer to a note containing such information, when the financial statements are prepared in accordance with (a) a regulatory or contractual basis of accounting or (b) an other basis of accounting and the auditor is required to restrict use of the auditor's report (pursuant to AU-C 905, *Alert That Restricts the Use of the Auditor's Written Communication*, at AU-C 905.06a–b).	AU-C 800.19a
• If management has a choice of financial reporting frameworks in the preparation of the special purpose financial statements, the explanation of management's responsibility for the financial statements section of the report should also be expanded to refer to management's obligation to determine that the applicable financial reporting framework is acceptable in the circumstances.	AU-C 800.19b
Except for financial statements prepared in accordance with the regulatory basis of accounting that are intended for general use, the auditor's report should include an *emphasis-of-matter* paragraph, under an appropriate heading that—	AU-C 800.20
• Indicates that the financial statements are prepared in accordance with a special purpose framework.	AU-C 800.20a
• Refers to a note to the financial statements that describes that framework.	AU-C 800.20b
• States that the special purpose framework is a basis of accounting other than GAAP.	AU-C 800.20c

Requirements/Guidance	AU-C Reference
• Includes a statement that the financial statements may not be suitable for another purpose when the auditor is required to restrict the use of the auditor's report, as described in AU-C 800.19a.	AU-C 800.20d
Also, except for financial statements prepared in accordance with the regulatory basis of accounting that are intended for general use, the auditor's report on special purpose financial statements should include an *other-matter* paragraph, under an appropriate heading that restricts the use of the report when the special purpose financial statements are prepared in accordance with— • a contractual basis of accounting, • a regulatory basis of accounting, or • an other basis of accounting when required pursuant to AU-C 905.06a or AU-C 905.06b.	AU-C 800.21
If the financial statements are prepared in accordance with a regulatory basis of accounting, and the statements and the auditor's report are intended for general use, the auditor's report should express an opinion about whether the financial statements are presented fairly, in all material respects, in accordance with GAAP. Further, in a separate paragraph, the auditor's report should express an opinion about whether the financial statements are prepared in accordance with the regulatory basis of accounting.	AU-C 800.22
If the auditor is required by law or regulation to use a specific layout, form, or wording of the auditor's report, the report should refer to GAAS only if the report includes, at a minimum, each of the following elements— • A title indicating that the auditor is independent. • An addressee. • A section that— •• identifies the special purpose financial statements audited, and •• contains an expression of opinion on the special purpose financial statements and a reference to the special purpose framework used to prepare the financial statements and, if applicable, an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with GAAP when required by AU-C 800.22. • A description of the purpose for which the financial statements are prepared when required by AU-C 800.19a. • A statement that the auditor is required to be independent of the entity and meet other ethical requirements pursuant to relevant ethical requirements for an audit. • When a going concern issue is applicable, a section that addresses the related reporting requirements in AU-C 570.24–.27. • A description of management's responsibilities for the preparation and fair presentation of the special purpose financial statements as stipulated by the requirements of AU-C 700.31–.33. • A reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances when required by AU-C 800.19b. • If applicable, a reference to the law or regulation and a description of the auditor's responsibilities for an audit of financial statements that meets and is consistent with the requirements of AU-C 700.35–.37.	AU-C 800.23

Requirements/Guidance	AU-C Reference
• An *emphasis-of-matter* paragraph that— •• indicates that the financial statements are prepared in accordance with a special purpose framework, which is a basis of accounting other than GAAP, and refers to a note in the financial statements that describes that framework, when required by AU-C 800.20a–c, and •• describes the purpose for which the financial statements are prepared (or refers to a note that includes such information) and states that the financial statements may not be suitable for another purpose, when required by AU-C 800.20d. • An *other-matter* paragraph that restricts the use of the auditor's report when required by AU-C 800.21. • The signature of the auditor's firm. • The city and state from where the auditor's report is issued. • The date of the auditor's report.	
If the prescribed specific layout, form, or wording of the auditor's report is not acceptable or would cause an auditor to make a statement that he or she has no basis to make, the auditor should reword the prescribed form of report or attach an appropriately worded separate report.	AU-C 800.24

Statements on Standards for Accounting and Review Services (SSARS)

The SSARS are comprised of the following sections—

- AR-C 60A, *General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services*—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. It provides the overall framework for conducting an engagement in accordance with the SSARS and defines certain terms used in the SSARS to describe the professional requirements imposed on accountants performing compilation and review engagements.

- AR-C 70A, *Preparation of Financial Statements*—applies when an accountant is engaged to prepare financial statements, but is not engaged to perform an audit, review, or compilation of those statements. Detailed information about preparation engagements is beyond the scope of this course. *PPC's Guide to SSARS Preparation Engagements* covers preparation engagements in detail.

- AR-C 80A, *Compilation Engagements*—establishes the standards and provides guidance on compilations of financial statements. The accountant is required to comply with those provisions whenever he or she is engaged to report on compiled financial statements. A detailed discussion of compilation reporting requirements is beyond the scope of this course, but certain performance requirements and considerations for compilation engagements are discussed in Lesson 2.

- AR-C 90A, *Review of Financial Statements*—establishes the standards and provides guidance on reviews of financial statements. The accountant is required to comply with those provisions whenever he or she is engaged to perform a review of financial statements, except for reviews of interim financial information when AU-C 930 applies. A detailed discussion of review reporting requirements is beyond the scope of this course, but certain performance requirements and considerations for review engagements are discussed in Lesson 2.

- AR-C 100, *Special Considerations—International Reporting Issues*, provides requirements and guidance when an accountant (a) performs a compilation or review in accordance with both the SSARS and another set of compilation or review standards, or (b) 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, and is not further discussed in this course.

- AR-C 120, *Compilation of Pro Forma Financial Information*—contains performance and reporting requirements to perform a compilation engagement on pro forma financial information. Pro forma financial information is beyond the scope of this course and is not further discussed.

Exhibit 1-2 provides a listing of the SSARS requirements that are specific to performing engagements of special purpose framework financial statements.

Exhibit 1-2

SSARS Engagements of Financial Statements Prepared Using a Special Purpose Framework[a]

Requirements/Guidance	AR-C Reference
Definitions:	
Special Purpose Framework—A financial reporting framework other than GAAP which is one of the following: • *Cash basis*—A basis of accounting used by the reporting entity to record cash receipts and disbursements. Additionally, modifications of the cash basis having substantial support. • *Tax basis*—The basis of accounting the entity uses to prepare its tax returns for the period covered by the financial statements. • *Regulatory basis*—A basis of accounting used by the entity to comply with requirements of a regulatory agency to whose jurisdiction the entity is subject. • *Contractual basis*—A basis of accounting used by the entity to comply with the financial reporting requirements of a contract between the entity and one or more third parties other than the practitioner. • *Other basis*—A basis of accounting with a definite set of logical, reasonable criteria that is applied to all material financial statement items.	AR-C 60A.07
Requirements:	
Considerations When Accepting the Engagement	
Prior to accepting the engagement, the accountant should determine whether the financial reporting framework is acceptable. This determination could include consideration of: • The nature of the entity (for example, a for-profit business entity or a nonprofit organization). • The purpose of the financial statements (i.e., limited number of users or wide range of users). • The nature of the financial statements (i.e., a complete set of financial statements or a balance sheet only). • Whether a particular financial reporting framework is prescribed by law or regulation.	AR-C 60A.26a; AR-C 60A.A53
Prior to accepting the engagement, the accountant should obtain agreement from management that it is responsible for the selection of the financial reporting framework.	AR-C 60A.26b(i)
Agreement on Engagement Terms	
The engagement letter should include the identification of the financial reporting framework to be used to prepare the financial statements.	AR-C 70A.10f; AR-C 80A.10e; AR-C 90A.16e

Requirements/Guidance	AR-C Reference
The engagement letter should include management's agreement that it is responsible for the preparation and presentation of the financial statements in accordance with the financial reporting framework.	AR-C 80A.08a; AR-C 90A.13a
Fair Presentation of Financial Statements	
In special purpose financial statements, fair presentation includes the following:	
• The inclusion of all applicable financial statement disclosures.	AR-C 80A.08a; AR-C 90A.13a
• A description of the financial reporting framework. This includes a summary of significant accounting policies and a description of how the framework differs from GAAP. Also, disclosures similar to those required by GAAP should be included if the financial statements include items that are the same as or similar to items in GAAP-basis financial statements.	AR-C 80A.08a(i); AR-C 80A.18; AR-C 90A.13a(i); AR-C 90A.77
• A description of any significant interpretations of a contract upon which contractual basis financial statements are prepared.	AR-C 80A.08a(ii); AR-C 90A.13a(ii)
• Additional disclosures necessary to achieve fair presentation.	AR-C 80A.08a(iii); AR-C 90A.13a(iii)
Financial Statement Preparation Engagements	
The financial statements should include a description of the financial reporting framework on the face of the financial statements or in a note to those statements.	AR-C 70A.15
Understanding the Financial Reporting Framework	
The accountant should understand the applicable financial reporting framework and how the significant accounting policies are used in the preparation of the financial statements.	AR-C 80A.12; AR-C 90A.22
Reporting on Compilation Engagements	
When management had a choice of which financial reporting framework to use in the preparation of the special purpose financial statements, the explanation of management's responsibility for the financial statements in the accountant's report should refer to management's responsibility to determine that the financial reporting framework is acceptable in the circumstances.	AR-C 80A.20
The accountant's report should include a separate paragraph (a) stating the financial statements were prepared using the applicable framework, (b) referencing a note to the financial statements describing the financial reporting framework (if applicable), and (c) stating the framework is not GAAP. When the statements are prepared on the contractual basis of accounting, that paragraph should also state that such financial statements may not be suitable for another purpose.	AR-C 80A.21
Unless the entity elected to omit substantially all disclosures, the accountant's report should be modified if the financial statements do not include (a) a description of the financial reporting framework, (b) a summary of significant accounting policies, (c) an adequate description of how the basis used differs from GAAP, and (d) informative disclosures similar to those required by GAAP when the statements contain items that are the same as or similar to GAAP.	AR-C 80A.18
The accountant's report should be modified if the accountant determines that the contractual basis financial statements do not adequately disclose significant interpretations of the contract upon which the financial statements are based.	AR-C 80A.19

Requirements/Guidance	AR-C Reference
Reporting on Review Engagements	
When management had a choice of which financial reporting framework to use in the preparation of the special purpose financial statements, the explanation of management's responsibility for the financial statements in the accountant's report should refer to management's responsibility to determine that the financial reporting framework is acceptable in the circumstances.	AR-C 90A.79
The accountant's report should include an emphasis-of-matter paragraph (a) stating the financial statements were prepared using the applicable framework, (b) referencing a note to the financial statements describing the financial reporting framework, (c) stating the framework is not GAAP, and (d) indicating that the accountant's conclusion is not modified with respect to this matter. Additionally, when the statements are prepared on the contractual basis of accounting, that paragraph should also state that such financial statements may not be suitable for another purpose.	AR-C 90A.80; AR-C 90A.90c
The accountant's report should be modified if the financial statements do not include (a) a description of the financial reporting framework, (b) a summary of significant accounting policies, (c) an adequate description of how the basis used differs from GAAP, and (d) informative disclosures similar to those required by GAAP when the statements contain items that are the same as or similar to GAAP.	AR-C 90A.77
The accountant's report should be modified if the accountant determines that the contractual basis financial statements do not adequately disclose significant interpretations of the contract upon which the financial statements are based.	AR-C 90A.78
If the financial statements are prepared in accordance with the contractual basis of accounting, include an other-matter paragraph restricting the use of the accountant's report following the guidance in AR-C 90A.104.	AR-C 90A.81; AR-C 90A.104

Note:

[a] This Exhibit is intended to list incremental requirements that are applicable to SSARS engagements involving special purpose financial statements. For a more complete discussion of engagement considerations, see Lesson 2. A detailed discussion of reporting requirements is beyond the scope of this course, but more information is available in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*.

AICPA *Code of Professional Conduct* and the Quality Control and Peer Review Standards

In addition to GAAP, GAAS, and the SSARS, other authoritative literature that is relevant to engagements of special purpose frameworks include the AICPA *Code of Professional Conduct*, the *Statements on Quality Control Standards*, and the *Standards for Performing and Reporting on Peer Reviews*.

AICPA *Code of Professional Conduct*. The AICPA *Code of Professional Conduct* (the Code) sets forth the fundamental principles of professional ethics that should be followed in a SSARS or auditing 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 Code into their own rules of conduct.

Maintaining independence is an important consideration for practitioners when performing services for attest clients. The Code provides requirements under the "Independence Rule" and its interpretations (ET 1.200) that AICPA members should follow in order to maintain their independence. Lesson 2 discusses independence issues in more detail, including the performance of nonattest services. It also includes overview information on the Code, as well as information about recent changes to the Code.

Quality Control and Peer Review Standards. AICPA quality control standards apply equally to GAAP and non-GAAP financial statements. Additionally, firms enrolled in the AICPA Peer Review Program are subject to the requirements of the AICPA Peer Review Standards. Thus, a firm should have procedures in place to ensure that it complies with those professional standards when it prepares, compiles, reviews, or audits special purpose framework financial statements. Lesson 2 provides further information on those standards.

International Financial Reporting Standards

The Council of the AICPA has designated the International Accounting Standards Board as the body to establish international financial reporting standards for both private and public entities pursuant to ET 1.310.001, *Compliance with Standards Rule*, and ET 1.320.001, *Accounting Principles Rule*, of the Code. This allows AICPA members the option of using International Financial Reporting Standards as an alternative to U.S. generally accepted accounting principles. This course does not address financial statements prepared in accordance with International Financial Reporting Standards.

RECENT GAAS AND SSARS DEVELOPMENTS THAT AFFECT SPECIAL PURPOSE FINANCIAL STATEMENTS

Recent GAAS Developments

Exhibit 1-3 includes a listing of recently issued auditing standards that could affect various aspects of performing audits of special purpose financial statements and summarizes whether the standards have been incorporated into this course. The paragraphs that follow discuss the recently issued standards in more detail.

Exhibit 1-3

Recently Issued Auditing Standards That Could Affect the Audits of Special Purpose Financial Statements[a]

Standard No.	Standard Title	Incorporated into This Course
SAS No. 142	*Audit Evidence*	Yes
SAS No. 143	*Auditing Accounting Estimates and Related Disclosures*	Yes
SAS No. 144	*Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*	Yes
SAS No. 145	*Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*	No[b]
SAS No. 146	*Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*	No[b]
SAS No. 147	*Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance With Laws and Regulations*	No
SAS No. 148	*Amendment to AU-C Section 935*	No[b]

Notes:

[a] SAS No. 148 addresses compliance audits and is beyond the scope of this course.

[b] SAS Nos. 145 through 148 will be incorporated into a future edition of this course.

SAS No. 142, *Audit Evidence*. In July 2020, the AICPA issued SAS No. 142, *Audit Evidence*. SAS No. 142, which is codified at AU-C 500, supersedes the previous guidance now codified at AU-C 500A, moves guidance on the use of management specialists to AU-C 501, and amends various other AU-C sections. Key areas of change or potential improvement in audit quality covered by SAS No. 142 and amendments include use of automated tools and techniques, corroborative and contradictory information, conscious and unconscious bias, use of external information sources, and the nuances of reliability of information as audit evidence. SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. Early implementation is permitted. This course incorporates the requirements of SAS No. 142 as needed.

SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*. Also in July 2020, the AICPA issued SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*, which addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. The standard retains the familiar requirement that the auditor's further procedures should include one or more of three approaches: (a) obtain evidence from events occurring up to the audit report date, (b) test how management made the estimate, or (c) develop the auditor's own point estimate or range. The new SAS adds requirements and guidance regarding assessment of risk of material misstatement, audit documentation, and communications to those charged with governance related to accounting estimates. SAS No. 143, which is codified at AU-C 540, supersedes *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, which is codified at AU-C 540A, and amends various other AU-C sections. SAS No. 143 is generally effective for audits of financial statements for periods ending on or after December 15, 2023. Based upon the effective date, this edition of the course does not fully incorporate SAS No. 143. However, SAS No. 143 amends SAS No. 134, AU-C sections 700 and 701, and those amendments are effective one year earlier (for audits of financial statements for periods ending on or after December 15, 2022). Those amendments, which are limited, are discussed as relevant in this edition of the course.

SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*. In June 2021, the AICPA issued SAS No. 144, *Amendments to AU-C Sections 501, 540 and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*. The SAS provides enhanced guidance on (a) evaluating the work of a management's specialist with regard to developing accounting estimates; (b) the use of information from third-party pricing services when evaluating estimates of fair value of financial instruments; and (c) using the work of an auditor's specialist. SAS No. 144 is generally effective for audits of financial statements for periods ending on or after December 15, 2023. Based upon the effective date, this edition of the course does not fully incorporate SAS No. 144.

SAS No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. In October 2021, the AICPA issued SAS No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. SAS No. 145 supersedes AU-C 315A and amends other auditing standards related to risk assessment. Key aspects of SAS No. 145 include requirements or clarifications related to assessment of the risks of material misstatement at the assertion level and requirements related to understanding the entity's system of internal control and the evaluation of the design of certain controls. SAS No. 145 is effective for audits of financial statements for periods ending on or after December 15, 2023. Based upon the effective date, this edition of the course does not incorporate SAS No. 145. SAS No. 145 is not intended to fundamentally change the manner in which the audit is performed, but rather clarifies and enhances key elements and definitions of the risk assessment process. The ultimate aim of SAS No. 145 is to equip the auditor to perform better risk assessments, and as a result, enhance audit quality.

SAS No. 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*. In June 2022, the AICPA issued SAS No. 146, *Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, as well as Quality Management Standard No. 1, *A Firm's System of Quality Management* (SQMS No. 1), and Quality Management Standard No. 2, *Engagement Quality Reviews* (SQMS No. 2), as part of its quality management standards project. SAS No. 146 supersedes AU-C 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, and amends various other AU-C sections. SQMS No. 1 supersedes SQCS No. 8, and SQMS No. 2 provides requirements for the appointment and eligibility of engagement quality reviewers and performance of engagement quality reviews. SAS No. 146 is effective for engagements conducted in accordance with GAAS for

periods beginning on or after December 15, 2025. The quality management standards in SQMS No. 1 are required to be designed and implemented by December 15, 2025, with an evaluation of the system of quality management to be performed within one year. SQMS No. 2 is effective for audits and reviews of financial statements for periods beginning on or after December 15, 2025, and for other engagements in a firm's accounting and auditing practice beginning on or after December 15, 2025. Future editions of this course will incorporate the requirements as the effective date nears.

SAS No. 147, *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance with Laws and Regulations.* In June 2022, the AICPA issued SAS No. 147, *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance with Laws and Regulations*, which amends SAS No. 122, AU-C 210, *Terms of Engagement*. SAS No. 147 is designed to further the public interest by enhancing communication between predecessor and successor auditors. SAS No. 147 requires the successor auditor to ask the predecessor auditor about identified or suspected fraud or noncompliance with laws and regulations if management has authorized the predecessor auditor to respond. A refusal to consent by the client would be a significant red flag that the auditor would consider in determining whether to accept the engagement. Under unusual circumstances, a predecessor auditor may decide not to fully respond to the auditor's inquires; however, the predecessor auditor should clearly state their response is limited. SAS No. 147 is effective for audits of financial statements for periods beginning on or after June 30, 2023, with early implementation permitted. Based on the effective date, the requirements of the new SAS have not been fully incorporated into this course.

Proposed SAS, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors).* In March 2022, the AICPA issued an exposure draft of a proposed SAS, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)*. The proposed SAS would supersede extant guidance in AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, and amend other AU-C sections to conform to the group audits standard. The tentative effective date, as proposed, would be for audits of financial statements for periods ending on or after December 15, 2026. Future editions of this course will be updated for any new developments.

Approach in this Course. Except for the unique aspects of auditing special purpose financial statements, neither this course nor *PPC's Guide to Cash, Tax, and Other Bases of Accounting* provides audit guidance in detail, but where guidance is provided, the discussions have been updated as indicated in the paragraphs above. If a SAS has only renumbered the authoritative codified references and not changed the underlying guidance, this course refers to the core or primary AU-C paragraph, as discussed below. If a SAS has changed the underlying guidance, this course discusses the guidance for both before and after implementation.

Changes to AU-C References. With the continued issuance of new auditing standards and the deferral of effective dates for other auditing standards, the AICPA made some unprecedented changes in how it organizes the SASs. The three "series" of AU-C references are as follows:

- AU-C XXX, the core series. The core or primary AU-C Section number with no alpha character after the number will be updated to include the latest SAS issued, regardless of its effective date, and will reflect the most recent literature. The core series contains all the auditing standards issued to date (through SAS No. 148 at the time this course was updated).
- AU-C XXXB series. The B series includes the auditing standards that apply before SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, is implemented and is a complete codification containing all AU-C standards before implementation of SAS No. 134. Each section is designated with a "B" suffix (AU-C XXXB, such as AU-C 700B). This section is intended to assist auditors and firms that are not implementing SAS Nos. 134–140 prior to the delayed effective date (as a result of the issuance of SAS No. 141). Upon implementing SAS Nos. 134–140, the AU-C XXXB series should not be used. Given that after the delay, SAS No. 134–140 were effective for audits of periods ending on or after December 15, 2021, this edition of the course fully incorporates SAS Nos. 134–140 and as such does not refer to the AU-C XXXB series.
- AU-C XXXA series. The A series includes the auditing standards that apply after implementation of SAS No. 134 and the related reporting standards (that is, the standards up through SAS No. 141), but before

implementation of SAS No. 142 or any subsequent SASs. Note that this is not a complete set of professional standards, but simply a bridge between the AU-C XXXB series and the AU-C XXX core series. At the time this course was updated, the AU-C XXXA series includes: AU-C 210A, *Terms of Engagement;* AU-C 220A, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards;* AU-C 315A, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement;* AU-C 500A, *Audit Evidence;* the related interpretations at AU-C 9500A; AU-C 501A, *Audit Evidence—Specific Considerations for Selected Items;* AU-C 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures;* and AU-C 620A, *Using the Work of an Auditor's Specialist*, and the related interpretation at AU-C 9620A. Amendments to other AU-C sections by those recently issued ASUs are not fully integrated into the core AU-C sections. Instead, there will be a Note at the beginning of each affected core AU-C section referring the user to the appropriate appendix for the related amendments. Based on the relevant effective dates of SAS No. 142 and the subsequently issued SASs, this edition of the course fully incorporates SAS No. 142, but does not fully incorporate SAS Nos. 143–147. As a result, this course uses AU-C 500 references to represent the implementation of SAS No. 142, *Audit Evidence*, but generally uses the applicable AU-C XXXA references for the other sections included in the AU-C XXXA series.

Recent SSARS Developments

SSARS No. 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services.* In June 2022, the Accounting and Review Services Committee (ARSC) issued SSARS No. 26, *Quality Management for an Engagement Conducted in Accordance with Statements on Standards for Accounting and Review Services*. Concurrently, the AICPA issued three additional standards that, together with SSARS No, 26, collectively are referred to as the "quality management standards." Those are Statement on Quality Management Standards (SQMS) No. 1, *A Firm's System of Quality Management*; SQMS No. 2, *Engagement Quality Reviews*; and SAS No. 146, *Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*. SQMS No. 1 supersedes Statement on Quality Control Standards No. 8, *A Firm's System of Quality Control*, and implements a risk-based approach to quality management, with additional quality system components and new robust requirements. SQMS No. 2 addresses the appointment and eligibility of the engagement quality reviewer and performance of engagement quality reviews. SSARS No. 26 conforms the SSARS with the other quality management standards and enhances the quality management objectives at the engagement level. Except for the amendment to AR-C 90A.16 discussed below, which is effective upon issuance, SSARS No. 26 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2025. Future editions of this course will be fully updated for the new SSARS.

SSARS No. 26 is codified as AR-C 60, AR-C 70, AR-C 80, and AR-C 90, which are referred to as the core sections of the SSARS. Extant (SSARS No. 25) standards are recodified as AR-C 60A, AR-C 70A, AR-C 80A, and AR-C 90A, respectively. Pre-SSARS No. 25 standards are recodified as AR-C 60B, AR-C 70B, AR-C 80B, and AR-C 90B, respectively. After December 31, 2022, the B section is expected to be eliminated. SQMS No. 1 and SQMS No. 2 are codified as QM 10 and QM 20, respectively. Pre-SQMS No. 1 standards (formerly QC 10) are recodified as QM 10.

SSARS No. 26 makes the following amendments to the SSARS—

- AR-C 60 Amendments
    - Revises the definition of *engagement partner* to include individuals appointed by the firm.
    - Adds the following definitions: *engagement quality review, engagement quality reviewer, inspection, network, network firm, partner, personnel, professional standards*, and *relevant ethical requirements*.
    - Expands the responsibilities of the engagement partner to include, among other things—
        - creating an environment that facilitates the quality management objectives,
        - being sufficiently and appropriately involved throughout the engagement, and
        - determining that sufficient and appropriate resources to perform the engagement are assigned or made available to the engagement team in a timely manner.

    - Explicitly requires the engagement partner to take overall responsibility for managing and achieving quality on the engagement.
    - Adds requirements for the engagement partner regarding compliance with ethical requirements.
    - Adds requirements for the engagement partner for monitoring and remediation.
    - Expands application guidance relating to new requirements.
- AR-C 70 Amendment
    - Clarifies that the signature on the disclaimer should be the accountant's firm name.
- AR-C 80 Amendment
    - Clarifies that the accountant's compilation report can include the manual or printed signature of the accountant's firm and provides application guidance about signatures.
- AR-C 90 Amendments
    - Clarifies that the accountant's review report can include the manual or printed signature of the accountant's firm and provides application guidance about signatures.
    - Adds guidance on documentation requirements that applies when the review engagement is subject to an engagement quality review.
    - Eliminates the requirement at AR-C 90A.16 that an engagement letter be obtained prior to beginning a review engagement. (Effective upon issuance)

SSARS No. 26 is available on the AICPA website at **www.aicpa.org/resources/download/aicpa-statement-on-standards-for-accounting-and-review-services-no-26** and on Checkpoint at **https://checkpoint.riag.com/**.

Approach in this Course. This edition of the course has not been updated for SSARS No. 26 or SQMS Nos. 1 and 2, with the exception of the amendment to AR-C 90A.16, which is effective upon issuance. As previously indicated, the authoritative references before the adoption of SSARS No. 26 are denoted with an A following the section number (e.g., AR-C 60B, AR-C 80B, etc.) and the quality control standards at QC 10 before the adoption of SQMS No. 1 have been recodified as QM 10A.

SELF-STUDY QUIZ

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

1. What is the term for the basis of accounting an entity uses to file its tax return for the period of time covered by the financial statements?

   a. Contractual basis.

   b. Other basis.

   c. Regulatory basis.

   d. Tax basis.

2. What is one of the responsibilities of the Private Company Council (PCC)?

   a. To implement the recommendations of the Private Company Financial Reporting Committee (PCFRC).

   b. To advise the FASB about GAAP alternatives that will meet the needs of those who use private companies' financial statements.

   c. To identify when using special purpose frameworks is a good solution for the issue of standards overload.

   d. To ensure practitioners involved with financial statements prepared using a special purpose framework are familiar with GAAP requirements.

3. AU-C 800 includes which of the following guidance about auditing financial statements prepared using a special purpose framework?

   a. The term *other comprehensive basis of accounting (OCBOA)* has replaced the term *special purpose framework* for audit engagements.

   b. The auditor needs a representation from management that the special purpose framework is acceptable for the entity's financial statements.

   c. The auditor must obtain management's agreement that it acknowledges and understands its responsibility to include all appropriate disclosures.

   d. Entities that use either the regulatory or the contractual basis of accounting have complete flexibility in how they present their financial statements.

4. What section of the SSARS provides guidance and standards for performing review engagements?

   a. AR-C 60A.

   b. AR-C 70A.

   c. AR-C 80A.

   d. AR-C 90A.

5. When performing a SSARS engagement, consideration of the nature of the entity, the purpose and nature of the financial statements, and whether a particular reporting framework is prescribed by law or regulation will help the practitioner determine which of the following?

   a. Whether to accept the engagement.

   b. Whether management agrees to its responsibilities for the engagement.

   c. What significant accounting policies were used in preparing the financial statements.

   d. Whether a compilation report on contractual basis statements needs to be modified.

6. The "Independence Rule" and its interpretations are part of which of the following?

   a. The AICPA *Code of Professional Conduct* (the Code).

   b. The AICPA Peer Review Standards.

   c. The AICPA Quality Control Standards.

   d. The International Financial Reporting Standards.

7. SAS No. 143 does which of the following?

   a. Moves guidance on the use of management specialists to AU-C 501.

   b. Adds new requirements and guidance about assessing the risk of material misstatement, audit documentation, and communications to those charged with governance related to accounting.

   c. Provides a new requirement that the auditor's further procedures should include obtaining evidence from the events occurring up to the audit report date.

   d. Makes clarifications related to assessment of the risks of material misstatement at the assertion level.

8. Which of the following is an amendment made by SSARS No. 26?

   a. Excluding individuals appointed by the firm from the definition of *engagement partner*.

   b. Expanding an engagement partner's responsibilities to include being sufficiently and appropriately involved throughout the engagement.

   c. Clarifying that the signature on the disclaimer discussed in AR-C 70 must be the name of an individual accountant.

   d. Adding guidance on the documentation requirements for review engagements that are subject to engagement quality reviews.

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. What is the term for the basis of accounting an entity uses to file its tax return for the period of time covered by the financial statements? **(Page 3)**

   a. Contractual basis. [This answer is incorrect. This is a basis of accounting used by the entity to comply with an agreement between the entity and one or more third parties other than the practitioner.]

   b. Other basis. [This answer is incorrect. This is a basis of accounting utilizing a definite set of logical and reasonable criteria that is applied to all material items within the financial statements. However, there is a more specific term that applies to the definition outlined above.]

   c. Regulatory basis. [This answer is incorrect. This is a basis of accounting used by the reporting entity to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject.]

   d. **Tax basis. [This answer is correct. AU-C 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, and the Statements on Standards for Accounting and Review Services (SSARS) allow the use of special purpose frameworks. One such framework is known as the tax basis. The tax basis is defined as a basis of accounting the reporting entity uses to file its tax return for the period covered by the financial statements. It is also known as the *income tax basis*.]**

2. What is one of the responsibilities of the Private Company Council (PCC)? **(Page 4)**

   a. To implement the recommendations of the Private Company Financial Reporting Committee (PCFRC). [This answer is incorrect. The PCFRC ceased to exist as of December 31, 2012, and was replaced by the PCC; therefore, the PCFRC does not impact the responsibilities of the PCC.]

   b. **To advise the FASB about GAAP alternatives that will meet the needs of those who use private companies' financial statements. [This answer is correct. The PCC was established to improve the process of establishing accounting standards for private companies. The responsibilities of the PCC are two-fold. First, the PCC advises the FASB on the appropriate accounting treatment for private companies for items currently being addressed by the FASB. Second, the PCC advises the FASB on possible GAAP alternatives to address the needs of users of the financial statements of private companies.]**

   c. To identify when using special purpose frameworks is a good solution for the issue of standards overload. [This answer is incorrect. On and off for decades, the AICPA has examined the issue of standards overload. A solution that has often been mentioned is the use of financial statements prepared under a financial reporting framework other than GAAP. However, the PCC's responsibilities are more specific than this.]

   d. To ensure practitioners involved with financial statements prepared using a special purpose framework are familiar with GAAP requirements. [This answer is incorrect. Practitioners who are involved with financial statements that are prepared using a special purpose framework still need to be familiar with GAAP requirements. When special purpose frameworks contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, the auditing standards and the SSARS require that the financial statements should include informative disclosures similar to those required by GAAP. However, the PCC's responsibilities are centered more around private companies and their financial statement users, not practitioners.]

3. AU-C 800 includes which of the following guidance about auditing financial statements prepared using a special purpose framework? **(Page 5)**

   a. The term *other comprehensive basis of accounting (OCBOA)* has replaced the term *special purpose framework* for audit engagements. [This answer is incorrect. The auditing standards have generally replaced OCBOA with the term *special purpose framework*, not the other way around.]

   b. The auditor needs a representation from management that the special purpose framework is acceptable for the entity's financial statements. [This answer is incorrect. Under AU-C 800, the auditor is required to determine whether the special purpose framework used to prepare the entity's financial statements is acceptable by obtaining an understanding of (1) the purpose for which the financial statements are prepared, (2) the intended users, and (3) the steps taken by management to determine that the framework is acceptable in the circumstances. The auditor cannot simply take management's word on the acceptability of the special purpose framework in a representation without performing other procedures.]

   c. **The auditor must obtain management's agreement that it acknowledges and understands its responsibility to include all appropriate disclosures. [This answer is correct. According to AU-C 800, the auditor is required to obtain management's agreement that it acknowledges and understands its responsibility to include all informative disclosures that are appropriate for the special purpose framework used to prepare the financial statements. Management's acknowledgment and understanding should also cover any additional disclosures necessary to achieve fair presentation in the financial statements. The auditor should evaluate whether such disclosures are necessary.]**

   d. Entities that use either the regulatory or the contractual basis of accounting have complete flexibility in how they present their financial statements. [This answer is incorrect. Based on the guidance in AU-C 800, when the special purpose framework is the regulatory or contractual basis, certain performance, reporting, and/or presentation requirements exist.]

4. What section of the SSARS provides guidance and standards for performing review engagements? **(Page 10)**

   a. AR-C 60A. [This answer is incorrect. AR-C 60A, *General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services*, 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. It provides the overall framework for conducting an engagement in accordance with the SSARS and defines certain terms used in the SSARS to describe the professional requirements imposed on accountants performing compilation and review engagements. Therefore, while accountings performing review engagements need to be familiar with AR-C 60A, this is not the SSARS guidance specifically related to review engagements. It is more general and overarching in nature.]

   b. AR-C 70A. [This answer is incorrect. AR-C 70A, *Preparation of Financial Statements*, 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, *Compilation Engagements*, establishes the standards and provides guidance on compilations of financial statements. Therefore, it is not applicable to review engagements.]

   d. **AR-C 90A. [This answer is correct. AR-C 90A, *Review of Financial Statements*, establishes the standards and provides guidance on reviews of financial statements. The accountants are required to comply with those provisions whenever they are engaged to perform a review of financial statements, except for reviews of interim financial information when AU-C 930 applies.]**

5. When performing a SSARS engagement, consideration of the nature of the entity, the purpose and nature of the financial statements, and whether a particular reporting framework is prescribed by law or regulation will help the practitioner determine which of the following? **(Page 11)**

   a. **Whether to accept the engagement. [This answer is correct. Before accepting a SSARS engagement related to financial statements prepared using a special purpose framework, the accountant should determine whether the financial reporting framework is acceptable. According to AR-C 60A.26a and AR-C 60A.A53, this determination could include consideration of (1) the nature of the entity (e.g., a for-profit business entity or a nonprofit organization); (2) the purpose of the financial statements (e.g., limited number of users or wide range of users); (3) the nature of the financial statements (e.g., a complete set of financial statements or a balance sheet only); and (4) whether a particular financial reporting framework is prescribed by law or regulation.]**

   b. Whether management agrees to its responsibilities for the engagement. [This answer is incorrect. Agreement of the engagement terms, including management's agreement that it is responsible for the preparation and presentation of the financial statements in accordance with the financial reporting framework, is included in the engagement letter. The considerations above are pertinent for a different decision related to a SSARS engagement.]

   c. What significant accounting policies were used in preparing the financial statements. [This answer is incorrect. According to AR-C 80A.12 and AR-C 90A.22, the accountant should understand the applicable financial reporting framework and how the significant accounting policies are used in the preparation of the financial statements. However, this understanding of the financial reporting framework is more in-depth than the determination that would be made using the information discussed above.]

   d. Whether a compilation report on contractual basis statements needs to be modified. [This answer is incorrect. According to AR-C 80A.19, the accountant's report should be modified if the accountant determines that the contractual basis financial statements do not adequately disclose significant interpretations of the contract upon which the financial statements are based. However, this decision is more specific to an individual engagement than the determination that can be made with the information outlined above. Therefore, there is a better answer to this question.]

6. The "Independence Rule" and its interpretations are part of which of the following? **(Page 13)**

   a. **The AICPA *Code of Professional Conduct* (the Code). [This answer is correct. The Code provides requirements under the "Independence Rule" and its interpretations (ET 1.200) that AICPA members should follow in order to maintain their independence.]**

   b. The AICPA Peer Review Standards. [This answer is incorrect. Firms enrolled in the AICPA Peer Review Program are subject to the requirements of the AICPA Peer Review Standards. The "Independence Rule" is not part of these standards.]

   c. The AICPA Quality Control Standards. [This answer is incorrect. AICPA quality control standards apply equally to GAAP and non-GAAP financial statements; therefore, they will apply to financial statements that use a special purpose framework. However, the "Independence Rule" is not part of the quality control standards.]

   d. The International Financial Reporting Standards. [This answer is incorrect. These standards are an alternative to U.S. GAAP. The "Independence Rule" referred to above, however, is part of U.S. GAAP.]

7. SAS No. 143 does which of the following? **(Page 15)**

   a. Moves guidance on the use of management specialists to AU-C 501. [This answer is incorrect. SAS No. 142, *Audit Evidence*, (not SAS No. 143) which is codified at AU-C 500, supersedes the previous guidance now codified at AU-C 500A, moves guidance on the use of management specialists to AU-C 501, and amends various other AU-C sections.]

b. **Adds new requirements and guidance about assessing the risk of material misstatement, audit documentation, and communications to those charged with governance related to accounting estimates. [This answer is correct. SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*, addresses the auditor's responsibilities related to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Among other things, this new SAS adds requirements and guidance regarding the assessment of risk of material misstatement, audit documentation, and communications to those charged with governance related to accounting estimates.]**

c. Provides a new requirement that the auditor's further procedures should include obtaining evidence from the events occurring up to the audit report date. [This answer is incorrect. SAS No. 143 retains the familiar requirement that the auditor's further procedures should include one or more of three approaches: (1) obtaining evidence from events occurring up to the audit report date, (2) testing how management made the estimate, or (3) developing the auditor's own point estimate or range. These are not, however, new requirements.]

d. Makes clarifications related to assessment of the risks of material misstatement at the assertion level. [This answer is incorrect. Among other things, SAS No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, includes requirements or clarifications related to assessment of the risks of material misstatement at the assertion level and requirements related to understanding the entity's system of internal control and the evaluation of the design of certain controls.]

8. Which of the following is an amendment made by SSARS No. 26? **(Page 17)**

a. Excluding individuals appointed by the firm from the definition of *engagement partner*. [This answer is incorrect. One of the amendments made by SSARS No. 26 to AR-C 60 is that it revises the definition of *engagement partner* to *include* individuals appointment by the firm, not exclude them.]

b. **Expanding an engagement partner's responsibilities to include being sufficiently and appropriately involved throughout the engagement. [This answer is correct. SSARS No. 26 is codified as AR-C 60, AR-C 70, AR-C 80, and AR-C 90, which are referred to as the core sections of the SSARS. One of SSARS No. 26's amendments to AR-C 60 is expanding the responsibilities of the engagement partner to include, among other things, (1) creating an environment that facilitates the quality management objectives, (2) being sufficiently and appropriately involved throughout the engagement, and (3) determining that sufficient and appropriate resources to perform the engagement are assigned or made available to the engagement team in a timely manner.]**

c. Clarifying that the signature on the disclaimer discussed in AR-C 70 must be the name of an individual accountant. [This answer is incorrect. SSARS No. 26 clarifies AR-C 70 to indicate that the signature on the disclaimer should be the accountant's *firm name*, not the individual's name.]

d. Adding guidance on the documentation requirements for review engagements that are subject to engagement quality reviews. [This answer is incorrect. SSARS No. 26 makes several amendments to AR-C 90 in relation to review engagements. One such amendment is adding guidance on the documentation requirements that apply when the review engagement is subject to an engagement quality review.]

DECIDING WHEN IT IS APPROPRIATE TO USE A SPECIAL PURPOSE FRAMEWORK

The use of a special purpose framework is beneficial to clients for many reasons. Because accountants do not need to consider the measurement requirements of GAAP, special purpose financial statements often can be prepared on a more timely basis and at less cost to the client. For example, if depreciation is the only difference between GAAP and the client's tax return, using the income tax basis can eliminate the need to prepare two sets of depreciation schedules. Special purpose financial statements also may provide information in a format familiar to the client. For example, cash basis financial statements can answer the basic question "Where did the money go?"

The AICPA has a practice aid, *Accounting and Financial Reporting Guidelines for Cash- and Tax-Basis Financial Statements* (the AICPA Practice Aid), that provides the following guidance on characteristics of entities that generally are good candidates for cash basis or income tax basis financial statements:

a. There are no third-party users of the financial statements (for example, the entity is a small closely held business with no third-party debt).

b. The entity's creditors do not require GAAP financial statements.

c. The cost of complying with GAAP would exceed the benefits (for example, a small construction contractor who would be required to account for long-term contracts using the percentage of completion method and would be required to compute deferred taxes).

d. The owners and managers are closely involved in the day-to-day operations of the business and have a fairly accurate picture of the entity's financial position.

e. The owners are primarily interested in cash flows (for example, a professional corporation of physicians that distributes its cash basis earnings through salaries, bonuses, and retirement plan contributions).

f. The owners are primarily interested in the tax implications of transactions (for example, partners in a partnership who are concerned about the effects of transactions on their personal tax returns).

g. The entity is not required to issue GAAP financial statements, nor does it expect to be.

AICPA members may download the practice aid at **https://us.aicpa.org/interestareas/centerforplainenglishaccounting/practice-aid-accounting-financial-reporting-guidelines-cash-tax-basis-financial-statements**. Relevant information from the AICPA Practice Aid is considered in various discussions within this course.

There are instances in which special purpose financial statements are not appropriate, however. The entity may have substantial unfunded obligations or commitments not recorded on the income tax basis (because they are not deductible until paid) or the cash basis (because they have not been paid). For example, under the accrual income tax basis (a) pension liabilities are recorded at the amount determined to be deductible, (b) leases are recorded under Internal Revenue Code (IRC) rules, (c) deferred compensation is recognized when paid, (d) potential environmental liabilities are recorded only when they meet the economic performance and all events tests of the IRC, and (e) interest due to a related party cannot be accrued and deducted. When such conditions exist, accountants should consider whether financial statements prepared using a special purpose framework could be misleading—especially if the financial statements omit substantially all disclosures.

In advising a client about the use of special purpose financial statements, accountants must have a clear idea about the user's needs. Perhaps a banker can use a cash basis financial statement generated by the client's accounting system if the entity accompanies it with an aged accounts receivable listing. On the other hand, an absentee owner may be able to use compiled cash basis financial statements that omit substantially all disclosures on an interim basis but needs full disclosure GAAP statements at year end. Companies reporting financial results to third parties ordinarily use GAAP for financial statements. The use of GAAP promotes comparability among financial statements, and users become familiar with GAAP through experience with it. Additionally, loan covenants may require GAAP financial statements and failure to provide such statements may result in a loan default.

Considerations When Accepting an Audit Engagement

Is the Financial Reporting Framework Acceptable? AU-C 210A, *Terms of Engagement*, requires the auditor to determine whether the financial reporting framework used in the preparation of the entity's financial statements is acceptable. AU-C 800.10 refers to that requirement and further indicates that when performing an audit of special purpose financial statements, the auditor should obtain an understanding of—

a. The purpose for which the financial statements are prepared.

b. The intended users of the financial statements.

c. The steps management has taken to determine that the applicable financial reporting framework is acceptable in the circumstances.

AU-C 800.A7–.A10 provides further information about AU-C 800.10, indicating that the following factors could be used by the auditor when he or she considers whether the specific type of special purpose framework applied in the preparation of the financial statements is acceptable—

- The financial information needs of the intended users.
- Whether the special purpose framework applied to the financial statements encompasses financial reporting standards that have been established by an authorized standard-setting organization that follows an established and transparent process, for example, the AICPA or the FASB. When such is the case, the financial reporting standards that support the special purpose framework applied will be presumed acceptable.
- When the financial reporting framework applied is required by law or regulation to be used in the preparation of the entity's special purpose financial statements, such a financial reporting framework is presumed acceptable (unless indications to the contrary exist). For example, this type of situation often occurs when a regulator establishes financial reporting provisions that must be met by those entities that it regulates.
- Whether the financial reporting framework applied, exhibits attributes that are normally exhibited by acceptable financial reporting frameworks. However, for special purpose frameworks, the relative importance to a particular engagement of each of the attributes normally exhibited by acceptable financial reporting frameworks is a matter of professional judgment.
- For financial statements prepared in accordance with a contractual basis of accounting, the parties to the contract might agree on significant interpretations of the contract, if any, that are the basis of the special purpose framework. If the parties cannot reach agreement, the auditor may determine that the framework is not acceptable.

Preconditions for an Audit Engagement. As mentioned above, under AU-C 210A, the auditor is required to establish whether certain preconditions for an audit are present, including whether the financial reporting framework to be used in the preparation of the financial statement is acceptable. In performing an audit of special purpose financial statements, AU-C 800.11 refers to the requirement in AU-C 210A and further requires the auditor to obtain managements' agreement that it acknowledges and understands its responsibility to include all informative disclosures that are appropriate for the special purpose framework used to prepare the entity's financial statements. These precondition requirements are further discussed in Lesson 2.

Considerations When Accepting a SSARS Engagement

Preconditions for a SSARS Engagement. AR-C 60A specifies certain conditions for accepting an engagement under the SSARS. According to AR-C 60A.26, one of the conditions requires the accountant to determine whether the framework selected by management for the preparation of the entity's financial statements is acceptable. The accountant may find the following factors relevant when making that determination (AR-C 60A.A53)—

- The purpose of the financial statements.
- Whether the financial reporting framework applied is required by law or regulation.
- The nature of the entity.
- The nature of the financial statements.

Additionally, AR-C 60A.A51–.A52 and AR-C 60A.A54–.A57 explain what an applicable financial reporting framework is and why an acceptable financial reporting framework is necessary. It also provides further explanation about determining the acceptability of the financial reporting framework and discusses the use of general purpose frameworks and special purpose frameworks. In addition to that information, the authors believe the information provided by AU-C 800.A7–.A10 (listed above) can also help the accountant determine the acceptability of the framework in a SSARS engagement.

In addition to the general preconditions for accepting a SSARS engagement required by AR-C 60A.26, AR-C 80A and AR-C 90A provide additional preconditions in compilation and review engagements if the financial statements are prepared using a special purpose framework. Those preconditions require certain disclosures regarding the applicable financial reporting framework. See further discussion in Lesson 2.

When Is Each Basis Appropriate?

Absent specific guidance from financial statement users, accountants need to consider issues such as the following before advising a client about which presentation to use.

- *Does the Entity Have Inventory?* If so, the pure cash basis may not be helpful.
- *What Basis of Accounting Does the Entity Use in Preparing Its Income Tax Returns?* If the accrual basis is used, preparing financial statements on the same basis makes sense.
- *Is the Entity Highly Leveraged?* Lenders may require GAAP financial statements.
- *Are There Outside Investors?* GAAP financial statements may provide information needed by such users.
- *Does the Entity's Cash Flow Parallel Its Income and Expenses?* The pure cash basis may be appropriate.
- *Does the Entity Anticipate Going Public?* If so, the entity will need a history of GAAP financial statements.
- *Was the Entity Formed for Tax Purposes?* If the answer is yes, the owners probably are interested in the tax effects of transactions, and the income tax basis would be appropriate.
- *Is the Entity Subject to Bonding Requirements?* Many bonding companies will only accept GAAP financial statements.

An in-depth discussion of each basis is beyond the scope of this course. This course provides basic information that will help to determine when use of a special purpose framework is appropriate. More detailed information about the bases of accounting is available in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*.

Cash and Modified Cash Bases. In practice, use of the pure cash basis is rare. Generally, it is limited to nonbusiness entities with very simple operations. Entities that might use the pure cash basis of accounting include school activity funds, fairs and other civic ventures, trusts and estates, political action committees, and political campaigns.

Use of the modified cash basis is more common. To help provide some consistency in its use, however, the authors recommend limiting it to entities whose operations are—

a. oriented toward cash receipts and disbursements,
b. not significantly influenced by financing of sales or purchases, and

c. relatively simple and without complexities (complexities such as manufacturing, development, or other conversion activities or acquisitions of property and equipment, for example) that require significant modifications.

Income Tax Basis. Typically, entities that use the income tax basis of accounting are either profit-oriented enterprises (such as small closely held companies for which conversion to GAAP would exceed the benefit), partnerships whose partnership agreements require the use of the income tax basis of accounting, or nonprofit organizations seeking relief from the requirements of GAAP.

Regulatory and Contractual Basis. Regulatory basis financial statements are prepared by many types of entities, including insurance companies, credit unions, some construction contractors, certain state and local governmental entities, and some nonprofit organizations. Contractual basis financial statements are prepared when an entity follows the provisions of a contract or agreement, which often requires at least some unique financial reporting calculations. Due to the unique provisions in the contract or agreement, it is common that interpretation is necessary with regard to measurement principles for the contractual basis.

Other Basis. Though outside the scope of this course, *PPC's Guide to Cash, Tax, and Other Bases of Accounting* addresses the other basis of accounting and considers whether specific accounting frameworks meet the qualifications of an *other basis*. Additionally, the FRF for SMEs discussed earlier in this lesson meets the criteria for the *other basis* type of special purpose framework.

Cost-effective Alternatives for Clients

As previously discussed, special purpose financial statements are one option for providing more timely information at less cost to some clients. The following paragraphs discuss some additional options to consider when recommending a level of service to a client. For certain clients, these options may offer cost-effective means of meeting a client's needs.

Using Special Purpose Frameworks for Interim Financial Statements and GAAP for Annual Financial Statements. One option that accountants may want to consider for some clients is using the cash, modified cash, or income tax basis of accounting for preparing interim financial statements and GAAP for preparing annual statements. Some accountants find that this is both efficient and cost effective. When the accountant performs a compilation engagement on the interim statements, it may be even more efficient and cost-effective to omit substantially all disclosures from the interim statements. (However, see the discussion below.) A detailed discussion of the considerations for preparing and reporting on interim special purpose financial statements is beyond the scope of this course, but more information is available in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*.

Compiling Financial Statements That Omit Substantially All Disclosures. If a client does not feel that full disclosure statements are cost-effective, then the accountant may be engaged to compile financial statements that omit substantially all of the disclosures required by a special purpose framework. According to AR-C 80A.26, a compilation report should not be issued on financial statements that omit substantially all disclosures if the omission would, in the accountant's professional judgment, be misleading to financial statement users. Additionally, other requirements relating to reporting on financial statements that omit substantially all disclosures should be followed.

PRIMARY ISSUES THAT MAY ARISE WHEN PREPARING SPECIAL PURPOSE FINANCIAL STATEMENTS

Recognition and Measurement

Transactions are recognized and measured in financial statements based on the basis of accounting used. Thus, cash basis financial statements do not recognize or measure transactions until cash is received or paid. Modified cash basis financial statements reflect transactions similarly except for certain transactions the entity elects to recognize and measure otherwise (for example, capitalizing property and equipment and charging their costs to expense over the periods benefited rather than expensing them in the period purchased). Income tax basis financial statements recognize transactions when they would be recognized in the entity's tax return, and then measure them based on amounts that would be reported in the return. GAAP recognition and measurement principles, such as the

requirement of FASB ASC 715-30-25-1 to recognize an asset or a liability for the funded status of a defined benefit pension plan, are not considered in special purpose financial statements (except to the extent the cash basis has been modified to adopt GAAP principles).

Recognizing and measuring transactions under the cash or modified cash basis and the income tax basis are discussed in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*. That *Guide* also discusses considerations for financial statements prepared on regulatory, contractual, and other bases of accounting. Users of this course should also look to *PPC's Guide to Preparing Financial Statements* for additional information on GAAP-related measurement and recognition principles.

Presentation

While transactions are recognized and measured following the applicable financial reporting framework, they generally should be presented in financial statements following GAAP presentation guidelines. That is, assets and liabilities should be presented in the statement of financial position, and revenues and expenses (measured in accordance with the applicable financial reporting framework) should be presented in the statement of operations. Furthermore, changes in retained earnings and other components of stockholders' equity generally should be presented following GAAP requirements.

A statement of cash flows is not required for special purpose financial statements because they do not purport to present financial position and results of operations in accordance with GAAP. However, an entity that follows either the modified cash basis or income tax basis may choose to present a statement of cash flows. In addition, because the pure cash method reports all transactions, including purchases of assets and receipts of loan proceeds, as cash receipts or disbursements, the only item that would be present in a pure cash basis statement of financial position would be cash and equity. Thus, the authors recommend presenting a single statement titled "Statement of Cash Receipts and Cash Disbursements" when financial statements are prepared on the pure cash basis.

Special purpose financial statement disclosures should be similar, but not necessarily identical to, those required by GAAP. Thus, items required to be presented on the face of GAAP financial statements may sometimes be disclosed in the notes to special purpose financial statements so long as the substance of the GAAP information is communicated.

Because cash basis and income tax basis financial statements do not purport to present financial position and results of operations in accordance with GAAP, they should not be captioned or otherwise referred to as "Balance Sheet," "Income Statement," etc. without appropriate modification. Such titles as "Statement of Assets, Liabilities, and Equity—Cash Basis (or Income Tax Basis)," "Statement of Assets and Liabilities Arising From Cash Transactions," "Balance Sheet—Modified Cash Basis," "Statement of Revenues and Expenses—Cash Basis (or Income Tax Basis)," "Statement of Revenues Collected and Expenses Paid," or other appropriate financial statement titles should be used.

Disclosures

Financial statements prepared on a special purpose framework require notes and other disclosures, unless the statements are prepared or compiled and management elects to omit substantially all disclosures. The disclosure requirements for special purpose frameworks are not defined in the accounting literature as they are for GAAP, however. Guidance is found in the auditing standards and the SSARS indicating that the basis of accounting and how it differs from GAAP should be disclosed. The guidance also points out that when financial statements contain items that are the same as, or similar to those in GAAP financial statements, the same type and extent of informative disclosure generally is appropriate. The guidance further indicates that disclosures related to matters that are not specifically identified on the face of the financial statements may be necessary to achieve fair presentation. The explanatory material at AU-C 800.A25–.A29 provides further information about achieving fair presentation through the disclosures in special purpose financial statements, and notes that in some cases, qualitative information could replace the quantitative information required by GAAP. While that explanatory material is not included in the SSARS, the authors believe it could be helpful in considering the fair presentation of disclosures for accountants performing compilation and review engagements.

Reporting

When reporting on special purpose financial statements, certain modifications should be made to the basic reports. The statement titles in the reports should reflect the applicable financial reporting framework statement titles. Audit, review, and compilation reports should disclose the basis of presentation, refer to a note that describes the framework, and include a statement that the framework is a basis of accounting other than GAAP. (Certain exclusions apply to compiled financial statements that omit substantially all disclosures.)

SELF-STUDY QUIZ

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

9. Based only on the information provided, which of the following businesses would be the best candidate for either cash or tax basis financial statements?

   a. HunterCo's financial statements are used by various third parties.

   b. Garrison Plumbing has creditors that require GAAP financial statements.

   c. The owners of Sandover Ltd. are not very involved in the daily operations of the business.

   d. Colt Construction is a small contractor with several long-term contracts.

10. Assuming there is no guidance from the financial statement users, financial statements prepared using the pure cash basis of accounting are most appropriate under what circumstances?

    a. The entity maintains an extensive inventory.

    b. The entity's cash flow runs parallel to its income and expenses.

    c. The entity anticipates going public in the next few years.

    d. The entity is subject to bonding requirements.

11. Which of the following statements best describes the presentation of special purpose financial statements?

    a. Special purpose financial statements are presented differently from GAAP financial statements.

    b. A statement of cash flows is required when presenting special purpose financial statements.

    c. The disclosures in special purpose financial statements are similar but not necessarily identical to those required by GAAP.

    d. "Balance Sheet" and "Income Statement" are appropriate titles for special purpose financial statements.

SELF-STUDY ANSWERS

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

9. Based only on the information provided, which of the following businesses would be the best candidate for either cash or tax basis financial statements? **(Page 25)**

   a. HunterCo's financial statements are used by various third parties. [This answer is incorrect. According to the AICPA's practice aid, *Accounting and Financial Reporting Guidelines for Cash- and Tax-Basis Financial Statements* (the AICPA Practice Aid), one characteristic of an entity that is a good candidate for cash basis or tax basis financial statements is one that has no third parties using its financial statements (e.g., the entity is a small closely held business with no third-party debt). Because HunterCo's financial statements are used by third parties, it is not a good candidate for the special purpose financial statements described in the AICPA Practice Aid.]

   b. Garrison Plumbing has creditors that require GAAP financial statements. [This answer is incorrect. According to the AICPA Practice Aid, if the entity's creditors do *not* require GAAP financial statements, the entity is a good candidate for cash basis or tax basis financial statements. However, because Garrison does face a requirement for GAAP financial statements, it is not a good candidate for special purpose financial statements.]

   c. The owners of Sandover Ltd. are not very involved in the daily operations of the business. [This answer is incorrect. When owners and managers are closely involved in the day-to-day operations of the business and have a fairly accurate picture of the entity's financial plan, the AICPA practice aid indicates that the business is a good candidate for cash basis or tax basis financial statements. As that is not the case in this scenario, Sandover should consider using GAAP financial statements.]

   d. **Colt Construction is a small contractor with several long-term contracts. [This answer is correct. When presenting GAAP financial statements, Colt Construction would be required to account for long-term contracts using the percentage-of-completion method and would be required to compute deferred taxes. Therefore, the cost of complying with GAAP would likely exceed the benefits for this company. As such, based on the guidance provided in the AICPA Practice Aid, Colt Construction is a good candidate for either cash or tax basis financial statements.]**

10. Assuming there is no guidance from the financial statement users, financial statements prepared using the pure cash basis of accounting are most appropriate under what circumstances? **(Page 27)**

    a. The entity maintains an extensive inventory. [This answer is incorrect. The pure cash basis is *less* likely to be helpful for entities that have inventory.]

    b. **The entity's cash flow runs parallel to its income and expenses. [This answer is correct. Absent specific guidance from financial statement users, accountants need to consider relevant issues before advising the client about which presentation to use. One such issue is whether the entity's cash flow parallels its income and expenses. If this is true, then the pure cash basis may be appropriate.]**

    c. The entity anticipates going public in the next few years. [This answer is incorrect. If an entity is considering going public, it will need a history of GAAP financial statements, so it should not present its financial statements using a special purpose framework such as the pure cash basis of accounting.]

    d. The entity is subject to bonding requirements. [This answer is incorrect. Many bonding companies will only accept GAAP financial statements. Therefore, under these circumstances, special purpose financial statements (including cash and tax basis statements) may not be appropriate.]

11. Which of the following statements best describes the presentation of special purpose financial statements? **(Page 29)**

    a. Special purpose financial statements are presented differently from GAAP financial statements. [This answer is incorrect. While transactions are recognized and measured following the applicable financial reporting framework, they generally should be presented in financial statements following GAAP presentation guidelines. That is, assets and liabilities should be presented in the statement of financial position, and revenues and expenses (measured in accordance with the applicable financial reporting framework) should be presented in the statement of operations. Furthermore, changes in retained earnings and other components of stockholders' equity generally should be presented following GAAP requirements.]

    b. A statement of cash flows is required when presenting special purpose financial statements. [This answer is incorrect. A statement of cash flows is *not* required for special purpose financial statements because they do not purport to present financial position and results of operations in accordance with GAAP.]

    c. **The disclosures in special purpose financial statements are similar but not necessarily identical to those required by GAAP. [This answer is correct. Special purpose financial statement disclosures should be similar, but not necessarily identical to, those required by GAAP. Thus, items required to be presented on the face of GAAP financial statements may sometimes be disclosed in the notes to special purpose financial statements so long as the substance of the GAAP information is communicated.]**

    d. "Balance Sheet" and "Income Statement" are appropriate titles for special purpose financial statements. [This answer is incorrect. Because cash basis and income tax basis financial statements do not purport to present financial position and results of operations in accordance with GAAP, they should *not* be captioned or otherwise referred to as "Balance Sheet," "Income Statement," etc. without appropriate modification. Instead, titles such as "Statement of Assets, Liabilities, and Equity—Cash Basis (or Income Tax Basis)" should be used.]

Lesson 2: Special Purpose Framework Engagement Considerations

INTRODUCTION

The authors believe that practitioners generally perform one of three basic services with regard to financial statements prepared using a financial reporting framework other than GAAP—audit, compilation, or review. The authors further believe compilation and review services are the primary financial statement services provided for financial statements prepared using a financial reporting framework other than GAAP. Accordingly, this lesson primarily focuses on the professional requirements of compilation and review engagements. Guidance in this lesson helps practitioners sort through some of the engagement considerations regarding these services. For additional guidance relating to the compilation, review, or audit of financial statements, practitioners may consult *PPC's Guide to Compilation and Review Engagements* or *PPC's Guide to Audits of Nonpublic Companies*. See the discussion of recently issued SASs and SSARSs and their impact on this edition of this *Guide* in Lesson 1.

Under AR-C 70A, *Preparation of Financial Statements* accountants may perform a financial statement preparation engagement, if engaged to do so. Such engagements also may commonly use financial reporting frameworks other than GAAP, such as the cash basis and income tax basis of accounting. Performing financial statement preparation engagements is discussed only minimally in this course and in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*, but it is discussed in detail in *PPC's Guide to SSARS Preparation Engagements*. That *Guide* is available at **tax.thomsonreuters.com** or by calling (800) 431-9025.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize how the quality control and peer review standards and the independence rules of the AICPA *Code of Professional Conduct* apply to special purpose framework engagements.
- Identify the compilation and review procedures that apply to special purpose framework engagements.
- Determine how engagement letters and management representation letters are treated in this type of engagement.

THE QUALITY CONTROL AND PEER REVIEW STANDARDS THAT AFFECT FINANCIAL STATEMENTS PREPARED USING A SPECIAL PURPOSE FRAMEWORK

AICPA quality control standards apply equally to GAAP and non-GAAP financial statements. Thus, a firm should have procedures in place to ensure that it is complying with those professional standards when it prepares, compiles, reviews, or audits special purpose framework financial statements. *PPC's Guide to Quality Control* and *PPC's Guide to Quality Control—Compilation and Review* illustrate suggested policies and procedures that address the elements of quality control.

Statement on Quality Control Standard No. 8

In June 2022, the AICPA issued Statement on Quality Management Standards (SQMS) No. 1, *A Firm's System of Quality Management*. SQMS No. 1 supersedes SQCS No. 8 and implements a risk-based approach to quality management, with additional quality system components and new robust requirements. Firms are required to design and implement systems of quality management in compliance with SQMS No. 1 by December 15, 2025, and to perform an evaluation of the system of quality management required by SQMS No. 1 within one year following December 15, 2025. Future editions of this course will be fully updated for SQMS No. 1. SQMS No. 1 is codified as QM 10 and Pre-SQMS No. 1 standards (formerly QC 10) are recodified as QM 10A.

SQCS No. 8 (QM 10A), *A Firm's System of Quality Control*, 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. Accordingly, a firm's system of quality control should be designed to provide the firm with reasonable assurance that (a) the firm and its personnel are complying with professional standards and applicable legal and regulatory requirements, and (b) reports issued by the firm are appropriate in the circumstances. In developing and maintaining its quality control system, a firm should establish (a) policies designed to achieve the objectives associated with obtaining reasonable assurance and (b) procedures required to implement and monitor compliance with those policies. In the context of QM 10A, *reasonable assurance* is a high level of assurance, but not absolute assurance.

The nature of the policies and procedures the firm develops to obtain reasonable assurance and comply with the requirements of QM 10A depends 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.
  - Number of offices.
  - Whether the firm is part of a network.

Elements of a Quality Control System. QM 10A.17 indicates that the firm's system of quality control should incorporate policies and procedures that address each of the following QC elements:

- *Leadership Responsibilities for Quality Within the Firm (Tone at the Top).* The firm establishes policies and procedures to promote an internal culture that is based on the recognition 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 the risks associated with performing the client engagement; (b) determines the firm has the competence, capabilities, and resources to perform the engagement; and (c) determines the firm can comply with legal and ethical requirements.
- *Human Resources.* The firm has sufficient personnel with the capabilities, competence, and commitment to ethical principles to (a) perform engagements in accordance with professional standards and legal and regulatory requirements, and (b) enable the firm to issue reports that are appropriate in the circumstances.
- *Engagement Performance.* Work performed by engagement personnel consistently complies with applicable professional standards and regulatory requirements, and the firm issues reports that are appropriate in the circumstances.
- *Monitoring.* The policies and procedures established by the firm for the other elements of quality control are relevant, adequate, and operating effectively.

Relationship of SSARS to Quality Control Standards. Statements on Quality Control Standards relate to the conduct of a firm's entire accounting practice. SSARS relate to the conduct on individual preparation, compilation, and review engagements. The quality control policies and procedures that a firm adopts could affect the conduct of an individual engagement and affect the firm's overall accounting practice. However, deficiencies or instances of noncompliance with a firm's quality control policies and procedures do not necessarily indicate that an engagement

was not performed in accordance with professional standards or that the accountant's report, if applicable, was not appropriate.

Documentation and Communication of the Firm's QC Policies and Procedures. QM 10A.18 requires that the firm document its QC policies and procedures. As previously mentioned, 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 for 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. QM 10A.18 also indicates that the firm should communicate its QC policies and procedures to firm personnel.

In addition to documenting and communicating the firm's quality control policies and procedures, performing monitoring of the firm's quality control system is also required. AICPA member firms that have an accounting and auditing practice also must undergo a peer review at least once every three years. *PPC's Guide to Quality Control* and *PPC's Guide to Quality Control—Compilation and Review*, are designed to assist firms in creating and maintaining the firm's system of quality control. Those guides illustrate suggested policies and procedures that address the elements of quality control listed earlier in this section. Additionally, those guides are integrated with the checklists and procedures that are presented in *PPC's Guide to Cash, Tax, and Other Bases of Accounting* and are updated annually to help keep firms aware of recent developments relating to quality control issues and peer reviews. [For order information call (800) 431-9025 or go to **tax.thomsonreuters.com**.]

Establishing Criteria for Engagement Quality Control Reviews (EQCR). Firms are required by QM 10A.38 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. 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 applicable.

Firms need to tailor EQCR criteria to address higher risk engagements based on the firm's particular circumstances. Any circumstance that creates an unusual or a higher level of engagement risk needs to be considered in establishing EQCR criteria. Because EQCR criteria are based on each firm's unique circumstances, it is necessary for the firm to consider revising its established EQCR criteria when firm circumstances change.

Engagement Level Quality Control Requirements of the SSARS and the SASs

In June 2022, the AICPA issued SQMS No. 2 *Engagement Quality Reviews*, which addresses the appointment and eligibility of the engagement quality reviewer and performance of engagement quality reviews. SQMS No. 2 is codified at QM 20 and is effective for audits or reviews of financial statements for periods beginning on or after December 15, 2025, and other engagements in the firm's accounting and auditing practice beginning on or after December 15, 2025. Future editions of this course will be fully updated for SQMS No. 2.

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, AR-C 60A includes engagement-level quality control requirements that address certain of the quality control elements of QM 10A. AU-C 220A, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, provides requirements and guidance for auditors as they implement each element of quality control during the performance of an audit of financial statements.

AR-C 60A and AU-C 220A place the responsibility to ensure compliance with these engagement-level quality control requirements primarily on the engagement partner. The SSARS engagement level quality control guidance is located at AR-C 60A.20–.24. All of AU-C 220A addresses engagement-level quality control guidance. For more information about the engagement level quality control requirements, related guidance, and how these requirements

relate to the quality control elements of QM 10A, see *PPC's Guide to Quality Control* or *PPC's Guide to Quality Control—Compilation and Review*.

AICPA Peer Review Standards

Applicability of Peer Review Requirements. If a CPA firm is a member of the AICPA and has an accounting and auditing practice as defined by the clarified peer review standards (PR-C 100.11), the firm is required to enroll in the AICPA Peer Review Program (PR-C 100.3). The peer review standards define an *accounting and auditing practice* as all engagements performed under the SASs; SSARSs (excluding those engagements for which SSARS have provided an exemption); SSAEs; *Government Auditing Standards* issued by the GAO (the Yellow Book); and PCAOB standards for engagements that are not subject to PCAOB permanent inspection.

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 are subject to peer review is "maybe." Firms performing only financial statement preparation engagements under AR-C 70A are not required to enroll in the peer review program and thus, are not subject to peer review. However, PR-C 100.A7 explains that firms may be required to enroll in the program by a regulatory body. In addition, PR-C 220.13 and PR-C 320.A4 state an engagement review captain will select a preparation engagement in one of the following situations: (1) it is the engagement partner's only level of service, (2) it is the firm's only engagement performed with disclosures, (3) it is the firm's only engagement performed without disclosures, or (4) it is necessary to meet the minimum requirement of two engagements selected for review.

Firms should be aware, however, that state board requirements may be more stringent. Accordingly, accountants need to check with their state society, state board, or other organization responsible for peer review about the applicability of its requirements to financial statement preparation engagements.

Types of Reviews. The clarified peer review standards provide for two types of reviews: a *system review* and an *engagement review*. Firms that perform audit engagements under the auditing standards or *Government Auditing Standards*, examinations under the SSAEs, or audits of non-SEC issuers performed under the standards of the PCAOB 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. Firms that do not perform any of these services are not required to undergo peer review.

Engagement Reviews. 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 is required in 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.

Procedures Checklists Should Comply with Peer Review and Other Authoritative 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 Cash, Tax, and Other Bases of Accounting* 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. However, all firms subject to peer review have responsibilities for the use of quality control materials as stated in the QCM Review Report as follows:

> Users of the materials and this report should carefully consider the scope of this review. They should also understand the intended uses and limitations of the materials as reflected in their user instructions and related information, as well as the level of explanatory guidance provided by the materials. Users of the materials are responsible for evaluating their suitability and implementing, tailoring, and augmenting the material as appropriate. Therefore, the reliability of the materials is also dependent on the effectiveness of these actions and could vary from user to user. Further, there may be important elements of a quality control system in accordance with the Statements on Quality Control Standards that are not included in the materials that have been subject to this review.

Accordingly, it is important for users of QCM to put procedures in place to ensure those responsibilities are met.

PPC's QCM Have Been Peer Reviewed. PPC's system for developing the checklists and practice aids used in its guides has been reviewed. Our peer review report, with a rating of *pass*, is located in the introductory material of *PPC's Guide to Cash, Tax, and Other Bases of Accounting*. 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.

THE AICPA *CODE OF PROFESSIONAL CONDUCT* AND INDEPENDENCE ISSUES

The AICPA *Code of Professional Conduct* (the Code) sets forth the fundamental principles of professional ethics that should be followed in a SSARS or auditing 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 Code into their own rules of conduct.

Complying with the Code's *Independence Rule* and its various interpretations is an important issue because the only type of attest report a CPA can issue on financial statements of a nonpublic entity when he or she is not independent is a compilation report. For many small businesses, the accountant may unknowingly provide services that impair his or her independence. Therefore, it is important for accountants to understand the various rules and regulations that govern independence. For example, 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. On the other hand, AR-C 70A financial statement preparation engagements do not include a report and do not require the assessment of independence. However, AR-C 70A.A5 notes that accountants who perform attest services for their financial statement preparation clients need to consider independence. Preparation of monthly financial statements, for example, can impair independence if certain safeguards are not in place. 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 section ET 1.200 of the Code. In addition to the Code, a variety of other nonauthoritative independence-related resources are available. The AICPA, through its website at **https://us.aicpa.org/interestareas/professionalethics/resources/tools**, provides resources, publications, and recent developments on the topic of professional ethics that include the *AICPA Plain English Guide to Independence*, an Independence Toolkit, and other resources. Additionally, *PPC's Guide to Quality Control—Compilation and Review* provides an "Independence Questionnaire" that covers the independence interpretations, *Conceptual*

Framework for Independence, and *Ethical Conflicts* guidance of the Code. That *Guide* may be ordered by calling (800) 431-9025 or at **tax.thomsonreuters.com**.

Independence requirements also can be found in the SSARS, auditing standards, and SSAEs. In addition, accountants that have nonprofit or governmental clients may be subject to the Government Accountability Office's (GAO) independence rules, which are more restrictive than the AICPA's independence rules. Those rules are included in the *Government Auditing Standards* (also known as the Yellow Book) and are available at **www.gao.gov**. Additional guidance is provided on these rules in *PPC's Guide to Single Audits*, *PPC's Guide to Audits of Nonprofit Organizations*, and *PPC's Guide to Audits of Local Governments*.

While the authoritative literature governing these various types of engagements contains a great deal of discussion about independence, the basic concepts are 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. Also, accountants cannot make management decisions for attest clients.

Conceptual Framework for Independence

The *Conceptual Framework for AICPA Independence Standards* (ET 1.210.010) describes the risk-based approach used by the AICPA's Professional Ethics Executive Committee (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 that address an accountant's particular independence circumstance, ET 1.210.010.01 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 providing 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 the attest engagement.

Impairment of Independence by Unpaid Fees

An accountant's independence can be impaired by unpaid fees. Specifically, ET 1.230.010.02–.07 indicates that an accountant's independence will be considered to be impaired if, when the current year's compilation, review, or audit report is issued, unpaid fees are both significant to the accountant and relate to professional services provided more than one year prior to the issue date of the current year's report. ET 1.230.010.03 states that the threat of independence being impaired would be at an acceptable level if at the time the accountant's report was issued the amount owed is clearly insignificant and relates to services provided less than one year prior to the date of the current year's report. ET 1.230.010.02–.07 includes factors for an accountant to consider when evaluating whether there are threats to independence because of unpaid fees, including the significance of the unpaid fees to the accountant, the length of time the fees have been due from the client, the client's agreement to pay the unpaid fees, and the accountant's assessment of factors affecting the client's ability to pay the fees. ET 1.230.010.04 provides certain safeguards for covered members when the threats are not at an acceptable level. Those safeguards include the following before the current year's attest report is issued: (1) having an appropriate person review the attest work, (2) obtaining a partial payment of the unpaid fees, (3) obtaining a payment schedule from the attest client, and (4) suspending further work on current attest engagements and not accepting new engagements with the attest client. AICPA Technical Q&A 705.01–.03 provide additional guidance on the impact of unpaid fees on 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 any unpaid fees from the prior year's engagements, including tax and consulting engagement fees, would impair the firm's independence on the current year's engagement.

Services That Impair an Accountant'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 an 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 an engagement, that impair his or her independence. The remainder of this section discusses the effect on independence of providing nonattest services to attest clients, including tax compliance and hosting services.

Nonattest Services. ET 0.400.04 defines an *attest engagement* as an engagement that requires independence. Audits, examinations, agreed-upon procedures engagements, reviews, and compilations are therefore attest engagements. As previously mentioned, 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 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, and/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 and document the suitability of their skills, knowledge, and/or experience. The authors note that failure to make this assessment and appropriately document it is a common peer review finding. In cases where the client is unable or unwilling to assume all of these 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 accountant may also choose 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 Cash, Tax, and Other Bases of Accounting*. Additionally, the client's responsibilities can be included in a representation letter when one is required.

During peer review, firms answer engagement questions regarding independence and nonattest services for each engagement selected for review. One of those questions asks the firm to describe their assessment and factors leading to their satisfaction that client personnel overseeing the service had sufficient skills, knowledge, and experience to oversee the nonattest service. This assessment should be documented. One option is to use the practice aid provided in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*.

Although performing one nonattest service might not impair independence (because all the requirements listed above are met), the cumulative effect of providing multiple nonattest services for the same client can increase the significance of threats to independence. As discussed in ET 1.295.020.02, before agreeing to perform the services, the accountant 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 accountant's independence would be impaired. Practitioners should document whether the performance of multiple nonattest services for the client creates a threat to independence.

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. 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. ET 1.295.030.02 lists common nonattest service activities and states that performance of the following activities, which are considered to be management responsibilities, would impair an accountant's independence if performed for an attest client:

- 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 addresses the nonattest service of providing 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 practitioner 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 on behalf of client management impairs independence unless the practitioner has legal authority to do so and—

- The taxing authority has prescribed procedures, allowing the taxpayer to permit the practitioner to sign and file a return on the taxpayer's 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 practitioner 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 his or her knowledge and belief.

- •• That the individual authorizes the practitioner (or another named member in the practitioner's firm) 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 practitioner represents the client in court to resolve a tax dispute.

In addition, under ET 1.295.110, 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.

In some cases, the accountant may assist with the client's internal audit function. ET 1.295.150 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 listed 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.

Should Proposing Journal Entries and Preparing Financial Statements in Connection with a Compilation, Review, or Audit Be Viewed as Bookkeeping and, Therefore, Nonattest Services? ET 1.295.120.01 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. As a practical matter, small and midsize nonpublic entities typically view proposing journal entries and preparing financial statements as part of the attest engagement. ET 1.295.010.06 considers activities such as financial statement preparation, cash to accrual conversions, and reconciliations performed by the member as nonattest services, even if the services are performed as part of an attest engagement. The authors believe that proposing adjustments of an entity's accounting records in connection with performing an attest engagement would not be considered a bookkeeping service and, thus, would not be subject to ET 1.295.

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 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, fixed asset and depreciation schedules, other supporting schedules, legal documents, etc., whether maintained electronically or in hard copy format.
- Serving as the client's business continuity or disaster recovery provider.

Nonattest Services FAQs. PEEC issued *Frequently Asked Questions: Nonattest Services* on nonattest services, available at **www.aicpa.org/content/dam/aicpa/interestareas/professionalethics/resources/tools/downloadabledocuments/nonattestservicesfaqs.pdf**. These FAQs are based on guidance the AICPA has provided in response to member's inquiries about nonattest services. The FAQs were updated in October 2021 to include additional answers related to hosting services. In addition to the Nonattest Services FAQs, the AICPA Professional Ethics Division also 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 **www.aicpa.org/interestareas/professionalethics/ethically-speaking.html**.

SELF-STUDY QUIZ

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

12. According to QM 10A.17, how should policies and procedures in a firm's quality control (QC) system address the human resources element of quality control?

    a. They should promote an internal culture that recognizes how essential quality control is.

    b. They should ensure that personnel comply with relevant ethical requirements.

    c. They should ensure that the work performed by engagement personnel complies with applicable standards and requirements.

    d. They should ensure that the firm has sufficient personnel with the appropriate characteristics to meet its needs.

13. Firms that perform audit engagements under the generally accepted auditing standards (GAAS) are required to have what type of peer review?

    a. A system review.

    b. An engagement review, but they can elect to have a system review.

    c. An engagement review; electing to have a system review is prohibited.

    d. No peer review is required.

14. The threat of litigation by either the client or the accountant is an example of which threat to independence?

    a. The adverse interest threat.

    b. The advocacy threat.

    c. The financial self-interest threat.

    d. The undue influence threat.

15. An accountant can do which of the following and still retain independence from an attest client?

    a. Setting a client's strategic direction.

    b. Assisting management with its responsibilities.

    c. Preparing source documents for a transaction.

    d. Having custody of the client's assets.

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.)**

12. According to QM 10A.17, how should policies and procedures in a firm's quality control (QC) system address the human resources element of quality control? **(Page 36)**

    a. They should promote an internal culture that recognizes how essential quality control is. [This answer is incorrect. This is part of the leadership responsibilities for quality within the firm (tone at the top), which is a different QC element from human resources. For that QC element, the firm should establish policies and procedures to promote an internal culture that is based on the recognition that quality is essential in performing engagements.]

    b. They should ensure that personnel comply with relevant ethical requirements. [This answer is incorrect. Policies and procedures that ensure the firm and its personnel comply with relevant ethical requirements relate to the relevant ethical requirements element of quality control, not human resources.]

    c. They should ensure that the work performed by engagement personnel complies with applicable standards and requirements. [This answer is incorrect. The firm's QC policies and procedures related to the engagement performance element of quality control should ensure that 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. The QC element of engagement performance is different than the QC element of human resources.]

    d. **They should ensure that the firm has sufficient personnel with the appropriate characteristics to meet its needs. [This answer is correct. Human resources is one of the QC elements discussed in QM 10A.17. The firm's system of quality control should incorporate policies and procedures that ensure the firm has sufficient personnel with the capabilities, competence, and commitment to ethical principles to (1) perform engagements in accordance with professional standards and legal and regulatory requirements and (2) enable the firm to issue reports that are appropriate in the circumstances.]**

13. Firms that perform audit engagements under the generally accepted auditing standards (GAAS) are required to have what type of peer review? **(Page 38)**

    a. **A system review. [This answer is correct. The clarified peer review standards provide for two types of reviews: a system review and an engagement review. Firms that perform audit engagements under the auditing standards or *Government Auditing Standards*, examinations under the SSAEs, or audits of non-SEC issuers performed under the standards of the PCAOB as their highest level of service are required to have a system review every three years.]**

    b. An engagement review, but they can elect to have a system review. [This answer is incorrect. 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 they may elect to have a system review.]

    c. An engagement review; electing to have a system review is prohibited. [This answer is incorrect. Based on the guidance provided in the peer review standards, entities that are required to have an engagement review due to the types of engagements they perform can elect to have a system review instead. This is not prohibited.]

    d. No peer review is required. [This answer is incorrect. Firms that do not perform any of the services that, according to the peer review standards, require them to have a system review or an engagement review are not required to undergo peer review at all. However, firms that perform GAAS audits are required to have a peer review once every three years.]

14. The threat of litigation by either the client or the accountant is an example of which threat to independence? **(Page 40)**

    a. **The adverse interest 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. One type of threat is the adverse interest threat. This threat occurs when actions or interests between the accountant and the client are in opposition, such as a threat of litigation by either party.]**

    b. The advocacy threat. [This answer is incorrect. The advocacy threat occurs when the accountant performs actions that promote an attest client's interests or position, such as representing a client in tax court.]

    c. The financial self-interest threat. [This answer is incorrect. This threat occurs when there is a potential benefit to an accountant from a financial relationship with an attest client. One example of this is excessive reliance by the accountant on revenue from a single attest client.]

    d. The undue influence threat. [This answer is incorrect. This threat occurs when there are attempts by an attest client's management to exercise influence over the accountant, such as the pressure to reduce audit procedures for the purpose of reducing audit fees.]

15. An accountant can do which of the following and still retain independence from an attest client? **(Page 41 and Page 43)**

    a. Setting a client's strategic direction. [This answer is incorrect. According to ET 1.295.030.02, setting policies or strategic direction for a client is a common nonattest service that will impair an accountant's independence from an attest client.]

    b. **Assisting management with its responsibilities. [This answer is correct. ET 1.295 describes the requirements that must be met in order for the performance of nonattest services for an attest client to *not* impair independence. Under this guidance, independence is considered to be impaired if accountants (or their firms) assume management responsibilities. However, accountants may assist management in those responsibilities without impairing independence.]**

    c. Preparing source documents for a transaction. [This answer is incorrect. Preparing source documents, in electronic or other form, that evidence the occurrence of a transaction is one common nonattest service, listed in ET 1.295.030.02, that will impair an accountant's independence from an attest client.]

    d. Having custody of the client's assets. [This answer is incorrect. ET 1.295.030.02 lists common nonattest service activities and states that performance of activities that are considered to be management responsibilities would impair an accountant's independence if performed for an attest client. Having custody of client assets is one such activity.]

COMPILATION AND REVIEW PROCEDURES

This section summarizes the authoritative literature that governs compilations and reviews of special purpose financial statements and discusses the related performance requirements.

Interaction with *PPC's Guide to Compilation and Review Engagements*

The discussion of compilations and reviews in this section is based on guidance contained in *PPC's Guide to Compilation and Review Engagements*. Although the compilation and review performance requirements are summarized in this section, the practitioner should be familiar with the requirements of the authoritative literature for performance, reporting, independence, ethics, and quality control.

Authoritative Literature

The authoritative literature for compilation and review services consists primarily of:

a. Statements on Standards for Accounting and Review Services.

b. AICPA *Code of Professional Conduct*.

c. Statements on Quality Control Standards.

Statements on Standards for Accounting and Review Services (SSARS)

Interim Financial Statements. In accordance with AR-C 90A.02, the SSARS are not applicable to reviews of interim financial information if all of the following conditions are met:

a. The entity's latest annual financial statements have been audited by the accountant or a predecessor.

b. The accountant has been engaged to audit the entity's current year financial statements or when it is expected that the current year financial statements will be audited, the appointment of another accountant to audit the current year financial statements is not effective prior to the period covered by the review.

c. The entity prepares its interim financial information using the same financial reporting framework as that used to prepare its annual financial statements.

In these instances, the accountant should perform the interim reviews in accordance with AU-C 930, *Interim Financial Information*. *PPC's Guide to Audits of Nonpublic Companies* contains guidance and practice aids to assist auditors in applying the provisions of AU-C 930.

Engagement Driven. The SSARS are *engagement driven*. In other words, they 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, as well as compiled pro forma 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 70A, *Preparation of Financial Statements*, as long as they are not engaged to do so? 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 70A.A25 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.

SSARS Non-reporting Option. AR-C 70A allows accountants to prepare financial statements without issuing a report, and does not limit the distribution of those statements. AR-C 70A also includes additional requirements related to engagement letters and prescribes certain information to be disclosed in or on the face of the financial statements.

AICPA *Code of Professional Conduct*

The AICPA *Code of Professional Conduct* provides guidance on independence in its *Independence Rule* (ET 1.200.001) and the related interpretations. Independence issues were discussed earlier in this lesson. In addition, when performing preparation, compilation, or review engagements, practitioners are required to comply with ET 1.300.001, which provides general standards that must be followed in any engagement. ET 1.310.001 effectively requires practitioners to comply with the SSARS for preparation, compilation, and review services. In addition, practitioners should use professional judgment and guidance from other accounting literature for areas not addressed in the SSARS.

Statements on Quality Control Standards (QM 10A)

QM 10A requires practitioners performing SSARS and auditing engagements to have a system of quality control and to document and communicate the firm's quality control policies and procedures. A system of quality control is a process (i.e., the firm's quality control policies and procedures) to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and legal and regulatory requirements, and issue reports that are appropriate in the circumstances. QM 10A applies to monthly and quarterly financial statements as well as year-end financial statements and was discussed further earlier in this course.

PPC's Guide to Quality Control and *PPC's Guide to Quality Control—Compilation and Review* provide detailed guidance and illustrations for compliance with the quality control standards. Practitioners need to be familiar with the guidance in one of these *Guides* or obtain equivalent knowledge of the quality control standards. Additionally, the authors believe the use of the optional checklists in *PPC's Guide to Cash, Tax, and Other Bases of Accounting* will be helpful to the practitioner in ensuring compliance with applicable engagement-related requirements of the quality control standards.

Practice Issues in 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 can ruin an otherwise successful career. This section addresses several practice issues that accountants ought to consider when performing compilation and review engagements.

Litigation Risks. Although there is a lack of published cases on SSARS engagements, liability claims against CPA firms strike at a rate of one claim per year for approximately every 120 professionals. Claims arising from compilation engagements alone comprise 6% of all malpractice claims filed each year. CPA firms that perform 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 consider using include—

- Quality control.
- Professional liability insurance.
- Other protective measures.
- Engagement letters (which are required in all financial statement preparation, compilation, and review engagements).

Quality Control. QM 10A establishes standards and provides guidance for a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. QM 10A 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.

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 significantly reduces the risk of 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 earlier in this lesson.

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 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. Additionally, 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 may turn to the following protective measures to minimize the impact of claims or potential claims against the firm:

a. Risk avoidance.

b. Firm structure.

c. Damage control.

<u>Risk Avoidance.</u> 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. Before accepting an engagement today, CPA firms must not only examine the economics of servicing the client but also the potential liability risks posed by the engagement. QM 10A requires firms to establish policies and procedures for client and engagement acceptance and continuance, discussed earlier in this lesson.

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 are discussed later 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) that, 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.

Damage Control. An essential aspect of loss prevention is damage control, which considers ways of containing potential liability problems and thereby minimizing their impact. Damage control procedures focus on responding quickly to threatened and actual liability claims and designating a response team to manage the internal process. With the aid of professional help, a CPA firm may usually take remedial actions that will mitigate the size of a pending or threatened claim.

Engagement Letters. Finally, as further discussed later in this lesson, the SSARS require practitioners to establish a written understanding with the client about the services to be performed for all SSARS engagements. That understanding is generally obtained by using an engagement letter. The form and content of the letters should be structured to help minimize legal liability. *PPC's Guide to Cash, Tax, and Other Bases of Accounting* contains illustrative engagement letters that were written to minimize the CPA's liability in SSARS engagements.

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 90A indicates 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. However, the SSARS obligate the accountant in both compilation (AR-C 80A.14) and review (AR-C 90A.45) 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 Responsibility. 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 is, including detecting fraud, noncompliance with laws and regulations, and internal control deficiencies. A written engagement letter is required by AR-C 70A.10, AR-C 80A.10, and AR-C 90A.16 and can be helpful in clarifying and documenting the understanding of the accountant's responsibility regarding fraud, noncompliance with laws and regulations, and internal control deficiencies. This written understanding should provide, among other things, that

the engagement cannot be relied upon to disclose errors, fraud, or noncompliance with laws and regulations. Engagement letters are discussed in more detail later in this lesson.

Whether an act is fraudulent or a violation of laws and regulations is a determination that may be beyond the accountant's professional competence. An accountant, in reporting on financial statements, presents himself or herself as one who is proficient in accounting and compilation and review services. The accountant's training, experience, and understanding of the client and its industry may provide a basis for recognition that some client acts coming to his or her attention may be fraudulent or a violation of laws and regulations. However, the determination as to whether a particular act is fraudulent or a violation of laws and regulations generally would 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 90A.60 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.
- Significant facts relating to any fraud or suspected fraud known to management that could have an 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. (If fraud is detected, additional representations may be warranted.)

Communication of Suspected Fraud and Noncompliance with Laws or Regulations. AR-C 90A.34–.36 address the question of what the accountant should do to communicate suspected fraud or noncompliance with laws or regulations discovered during the performance of a review engagement. When the accountant suspects that fraud or noncompliance with laws or 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 or regulations that are clearly inconsequential 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 or 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 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 act may have occurred to third parties is not usually part of 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. The accountant ought to contact the firm's legal counsel prior to making any communications about fraud.

Other Practice Issues

Bookkeeping Services. Accountants who perform SSARS engagements for their clients also often perform bookkeeping services for those same clients. Bookkeeping engagements have often 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 in all engagements. The accountant's responsibility to detect fraud based on professional standards often differs from the public's perception of those responsibilities. See the discussion of the accountant's responsibility for fraud in SSARS engagements 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 check images to review for the 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, the District of Columbia, Puerto Rico, Guam, and the 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. The licensing rules may vary from state to state. Consequently, prior to doing business in another state, the CPA firm should investigate the state licensing requirements for that state by contacting the applicable state board or consulting an attorney.

Compilation Procedures and Checklists

AR-C 80A establishes the performance requirements for compilation engagements, which include complying with AR-C 60A as indicated by AR-C 80A.06. A practitioner who compiles financial statements should—

a. Address accepting or continuing the engagement (AR-C 80A.08–.09).

b. Establish an understanding with the entity regarding the services to be performed and document the understanding through a written communication with management (AR-C 80A.10). AR-C 80A.11 also

requires that the engagement letter be signed by both the accountant or the accountant's firm and management or those charged with governance.

c. Have, or obtain, an understanding of the applicable financial reporting framework and the significant accounting policies to be used in the preparation of the financial statements (AR-C 80A.12). This understanding is generally obtained throughout the engagement and through experience with the client or its industry. The understanding of the accounting policies used by the client includes the accounting principles and practices used in measuring, recognizing, recording, and disclosing all significant accounts and disclosures in the financial statements. The accountant should exercise professional judgment and consider the effect of any changes in accounting practices and principles and differences from industry norms.

d. Read the compiled financial statements and consider whether they appear to be appropriate in form and free from obvious material misstatements (AR-C 80A.13).

e. Take certain actions when the practitioner becomes aware that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory (AR-C 80A.14 and AR-C 80A.16a). Such actions include requesting additional or revised information in situations where the accountant believes the financial statements may be materially misstated. Refusal by the entity to provide the requested information should make the accountant consider withdrawing from the engagement. (Discussion with legal counsel is recommended prior to any engagement withdrawal.)

f. Take certain actions, including proposing revisions to management or withdrawing if revisions are not made, when the accountant becomes aware of any of the following:

  •• the applicable financial reporting framework is not adequately referred to or described in the financial statements,

  •• the financial statements require adjustment to comply with the applicable financial reporting framework, or

  •• the financial statements are otherwise misleading (AR-C 80A.15 and AR-C 80A.16b).

g. Prepare documentation in sufficient detail to provide a clear understanding of the work performed (AR-C 80A.40). The accountant's documentation should include, but is not limited to—

  •• Acceptance or continuance decision.

  •• Engagement letter.

  •• Justification for a departure from a relatively mandatory requirement and how the alternative procedure performed achieved the intent of the requirement, if applicable (AR-C 60A.17).

  •• Financial statements.

  •• Accountant's compilation report.

The authors believe it is a best practice for the compilation workpapers to only include what is required by standards. That is, accountants should (a) avoid extraneous clutter in the compilation workpapers, (b) adhere to the minimum compilation documentation requirements above, and (c) only go beyond those requirements when needed to provide a clear understanding of the work performed. To do otherwise may subject accountants to increased malpractice risks. Additionally, it should be noted that the SSARS may apply to interim financial statements as well as annual financial statements.

PPC's *SMART Practice Aids—Compilation and Review* and Checkpoint Engage are innovative tools that automate the design, performance, and review of the compilation or review procedures and dynamically generate customized procedures based on the accountant's judgment and consideration of the specific client and engagement. They also bring enhanced functionality to existing Practice Aid products, such as those included in Checkpoint Tools—PPC's *Practice Aids—Cash, Tax, and Other Bases of Accounting*, by automating specific processes and generating completed practice aids.

Compilation Engagement Checklists and Practice Aids. Engagement performance is one of the six quality control elements that QM 10A requires a firm's policies and procedures to address. Most firms address the compilation engagement performance QM requirements with the use of standardized compilation checklists. However, the checklists they use may not contain the steps necessary to *sufficiently* document compliance with the QC standards.

The checklists and practice aids developed by the authors *PPC's Guide to Cash, Tax, and Other Bases of Accounting* for a typical compilation of special purpose financial statements are listed in Exhibit 2-1. Although not required by the authoritative literature, they are designed to assist practitioners in complying with the applicable performance and reporting requirements for special purpose framework compilation engagements. The following paragraphs discuss the use of those checklists and practice aids, which have been adapted from *PPC's Guide to Compilation and Review Engagements*.

Exhibit 2-1 lists the checklists contained in *PPC's Guide to Cash, Tax, and Other Bases of Accounting* to design a system of quality control that addresses the compilation engagement performance and client/engagement acceptance and continuance requirements of QM 10A. The other quality control elements are discussed in *PPC's Guide to Quality Control* (GQC) and *PPC's Guide to Quality Control—Compilation and Review* (GCR). In addition, the "Engagement Performance Bridging Document with QCM Described—SSARS Engagements" ties the requirements of QM 10A to the practice aids in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*. The exhibit pertains to year-end engagements only. Interim engagements are outside the scope of this course.

Exhibit 2-1

Compilation Practice Aids

1. Engagement Letter for Compilation, Bookkeeping, and Financial Statement Preparation Services of Special Purpose Framework Financial Statements
2. Compilation Procedures, Review, and Approval Form (Comprehensive) for Special Purpose Framework Engagements
3. Engagement Acceptance and Continuance Form for Special Purpose Framework Engagements
4. Client Information Form for Special Purpose Framework Engagements
5. Compilation Reporting Checklist for Special Purpose Frameworks Engagements
6. Disclosure Checklist for Cash Basis Financial Statements
7. Disclosure Checklist for Income Tax Basis Financial Statements
8. Journal Entry Approval Form
9. Engagement Independence Compliance and Nonattest Services Documentation Form
10. Accounting and Engagement Issues

Compilation Procedures, Review, and Approval Form for Special Purpose Framework Engagements. The "Compilation Procedures, Review, and Approval Form (Comprehensive) for Special Purpose Framework Engagements" provides documentation of compliance with professional standards and peer review requirements. The staff person in charge of the compilation engagement generally should complete the compilation procedures section of the form. The technical review section of the form will typically be completed by the engagement partner. However, firm policy may designate another senior engagement member, such as a manager, to perform the technical review instead. Completion of the engagement quality control review section is required only at the engagement partner's option or if the firm's quality control policies and procedures require it. If performed, the engagement quality control reviewer should not be a member of the engagement team and should satisfy the independence requirements relating to the engagements reviewed. The review should be completed before the report is released. In instances

where accountants prepare monthly or quarterly compilations, the authors believe the engagement partner or partner equivalent should review each interim or quarterly financial statement and sign off on the technical review.

Various steps on the form include expanded discussions or memory joggers highlighting items accountants should consider when completing engagements. The authors recommend using this form for all year-end compilations and the first interim compilation of the year.

Engagement Acceptance and Continuance Form for Special Purpose Framework Engagements. AR-C 60A.25–.26 has requirements related to the acceptance and continuance of client relationships and engagements. In addition, QM 10A requires CPA firms to establish policies and procedures for acceptance and continuance of client relationships and specific engagements. Consequently, before a firm accepts a SSARS engagement, the firm should carefully consider whether it should be associated with the client and/or the engagement. QM 10A also requires accountants to document issues identified during the client acceptance and continuance process if the firm decides to accept or continue the client relationship. The "Engagement Acceptance and Continuance Form for Special Purpose Framework Engagements" is designed to assist a firm in complying with the requirements of AR-C 60A, in making the decision to accept a new client, and in evaluating the desirability of continuing to perform an engagement for an existing client, particularly when a situation arises that would have caused the firm to reject the client or engagement initially. The form can also be used to document issues identified in the client acceptance and continuance process.

Client Information Form for Special Purpose Framework Engagements. The "Client Information Form for Special Purpose Framework Engagements" is designed to document compliance with AR-C 80A.12 regarding the knowledge required for a compilation, and AR-C 90A.21–.23 regarding the level of knowledge necessary for a review engagement. The knowledge required for a review engagement is somewhat more comprehensive than for a compilation engagement. However, rather than use two separate forms, the authors have chosen to use one form that meets both requirements since the time necessary to complete the additional review engagement information is minimal. The form is generally reviewed annually by the personnel assigned to the client and updated for any changes in the client's operations.

Compilation Reporting Checklist for Special Purpose Framework Engagements. The checklist is designed to document the SSARS reporting requirements when accountants compile special purpose financial statements. It should be emphasized, however, that the checklist cannot be a substitute for an accountants' exercise of professional judgment and knowledge of the SSARS.

Disclosure Checklist for Cash Basis Financial Statements and Disclosure Checklist for Income Tax Basis Financial Statements. The authors designed these checklists to help accountants evaluate the adequacy of the disclosures in cash and income tax basis financial statements. They should be used in the manner that is most helpful to the accountant. For example, the accountant may choose to complete the checklist for each engagement involving cash or income tax basis financial statements that do not omit substantially all disclosures. Similarly, the accountant may also choose to only use the checklist as a memory jogger rather than completing the checklist. However, the authors recommend that accountants who are not comfortable applying cash or income tax basis disclosure requirements complete a disclosure checklist on every engagement in which substantially all disclosures are not omitted. Whether or not a checklist is completed, accountants should always be alert for situations that might require changes from the disclosures presented in the prior financial statements.

Review Procedures and Checklists

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 90A contains the performance requirements for a review, which include complying with AR-C 60A as indicated by AR-C 90A.09. 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 90A.16). SSARS No. 26 removes the previous explicit requirement to agree on the terms of the engagement prior to performing the engagement to better conform with the professional standards for compilations and audits.

b. Communicate with management or those charged with governance regarding significant matters that arise during the review engagement (AR-C 90A.18).

c. Determine materiality (AR-C 90A.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 90A.21–.23).

e. Design and perform review procedures with professional skepticism based on the accountant's—(AR-C 90A.11 and AR-C 90A.24–.25).

   (1) understanding of the industry,

   (2) knowledge of the client, and

   (3) awareness of the risk of unknowingly issuing an inappropriate review report.

f. Perform appropriate inquiry, analytical, and other procedures (AR-C 90A.26–.30).

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 90A.31).

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 90A.32–.38).

i. Communicate with and obtain and read reports from other accountants who issued a report on the financial statements of significant components or other experts who performed work (AR-C 90A.39–.40 and AR-C 90A.124).

j. Determine that the financial statements reviewed reconcile to the underlying accounting records (AR-C 90A.41).

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 90A.42 and AR-C 90A.45–.48).

l. Form a conclusion.

m. Prepare appropriate documentation (AR-C 90A.137–.139) in sufficient detail to allow an experienced accountant who is not a member of the engagement team, to understand (1) the nature, timing, and extent of the procedures performed; (2) the results of the procedures performed and evidence obtained; and (3) significant findings or issues arising during the review, the conclusions, reached, and judgments made in reaching those conclusions. Appropriate review documentation includes—

   (1) Acceptance or continuance decision.

   (2) Engagement letter.

   (3) Communications with management regarding fraud or noncompliance with laws and regulations (AR-C 90A.34).

   (4) Communications with management about the accountant's expectation to include an emphasis-of-matter or other-matter paragraph in the accountant's review report.

(5) Communications with other accountants that have audited or reviewed the financial statements of significant components.

(6) Justification for a departure from a relatively mandatory requirement and how the alternative procedure performed achieved the intent of the requirement, if applicable (AR-C 60A.17).

(7) Description of how any inconsistencies or findings regarding significant matters affecting the financial statements were addressed, if any such items were identified during the course of the engagement.

(8) Representation letter.

(9) Financial statements.

(10) Accountant's review report.

(11) Communications with management, those charged with governance, and others about significant matters, including their nature, that surface during the engagement.

(12) Information that is inconsistent with the accountant's findings about significant matters affecting the financial statements and how the inconsistencies were addressed.

(13) Who performed the review procedures and the date the procedures were completed.

(14) Who performed the technical review necessary to ensure engagement quality control, the extent of the review, and the date the review was performed.

n. Request representations from management for all financial statements and periods covered by the accountant's review report (AR-C 90A.58–.63).

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.

Designing and Performing Review Procedures. AR-C 90A.24 and AR-C 90A.A45 indicate that the accountant should plan and 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, which should be designed and performed to address all material items in the financial statements, including disclosures. AR-C 90A.11 explicitly requires the accountant to plan and perform those procedures with professional skepticism.

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 (AR-C 90A.25). For example, if the CFO of the company was previously a manager with a respected accounting firm and has been the CFO of the company 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 for a first year review client. AR-C 90A.25 requires the accountant to design and perform analytical procedures and inquiries to address all material items in the financial statements (including disclosures).

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.

Inquiries. AR-C 90A.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 conformity with the applicable special purpose framework, including how management has 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 affect on the financial statements, including the following:

   (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 that 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. (While AR-C 90A.29 indicates that the accountant should inquire about actions taken at meetings of stockholders, board of directors, etc., obtaining formal copies of the minutes may prove futile in many cases because many closely held companies do not prepare formal records of such meetings.)

m. Any other matters that the accountant may deem necessary.

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.

Analytical Procedures. The accountant should apply analytical procedures to the financial statements to identify and provide a basis for inquiries about relationships and individual items that appear to be unusual and that may indicate a material misstatement. 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. AR-C 90A.26–.27 indicate that analytical procedures *should* include—

a. Comparing financial statements with comparative information for the prior period.

b. Considering plausible relationships among both financial and relevant nonfinancial information.

c. Comparing recorded amounts, or ratios developed from recorded amounts, to expectations.

d. 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.

AR-C 90A.27 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 that differences exist between the expectation and the recorded amount or ratio. If such differences are significant, they may be indicative of material misstatements, and the accountant should obtain explanations for such differences.

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.
- Discussions with management prior to creating the expectation.
- Industry data.
- Nonfinancial 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. *Environmental, Societal, and Other Conditions.* Consider the impact of external events on the accountant's ability to develop the required expectations for analytical procedures. Comparisons between the current and prior periods will most likely not be useful if operations were significantly disrupted by a significant external event, such as the recent COVID-19 pandemic. Comparison to realistic budgets prepared by clients may have to be used because past trends and relationships may no longer be predictive in the short term or the medium term, depending on the extent of the disruption.

c. *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.

d. *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, such as developing expectations of fixed expenses based on prior-year balances.

e. *The Number of Expectations Needed for an Account.* Ordinarily, there is no need to develop more than one expectation for an account. Also, if two or more expectations are equally effective, the accountant selects the one that is most efficient to develop or use.

AR-C 90A.137 does not specifically state what should be documented with respect to the analytical procedures performed. (However, accountants will want to ensure that the review documentation supports that the analytical procedures have been performed so that the review documentation is appropriate as noted in item l in the list of performance requirements from AR-C 90A provided earlier in this section.) *PPC's Guide to Cash, Tax, and Other Bases of Accounting* provides an optional form that has been developed to assist accountants in complying with these documentation requirements. Exhibit 2-2 is an example of such a partially filled-out form.

Exhibit 2-2

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 discussion of performance requirements from AR-C 90A provided earlier 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.

PPC's Guide to Compilation and Review Engagements provides further guidance on performing appropriate analytical procedures, including developing and documenting expectations. For PPC's *SMART Practice Aids—Compilation and Review* users, a "SMART Analytical Procedures Documentation Form" is available. This form provides a list of common ratios by financial statement area, allows accountants to tailor the list, calculates the selected ratios, and provides a guide for documenting the analytical procedures performed.

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 90A.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 90A.40 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.

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 90A.124, 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. (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 90A.A194 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 90A.138 states that the review engagement documentation should include these communications with the other accountants.

AR-C 90A.31 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. In addition, 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 90A.40 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.

Related Parties. AR-C 90A.32 requires the accountant to be alert for arrangements or information that may indicate the existence of related-party relationships or transactions that have not been identified or previously disclosed by management. In addition, if significant transactions outside the entity's normal course of business are identified by the accountant when performing review procedures AR-C 90A.33 requires the accountant to inquire of management about the nature of the transactions and whether they could involve related parties.

Fraud and Noncompliance with Laws and Regulations. According to AR-C 90A.34–.35, procedures the accountant should perform after becoming aware that fraud or noncompliance with laws or regulations has occurred, or the accountant 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 or suspicion 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 90A.36).

Going Concern Considerations. According to AR-C 90A.38, 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 90A.08] 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 90A.60 requires management representation related to going concern for all review engagements whether or not there is a going concern uncertainty. There are also reporting considerations if there are uncertainties about the entity's ability to continue as a going concern. Though outside the scope of this course, those considerations are discussed in more detail in relation to audit reports in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*.

Communication of Significant Matters. AR-C 90A.18 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.

AR-C 90A.118 requires the accountant to document in writing any 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 from communicating certain matters with management or those charged with governance. In those circumstances, accountants may consider obtaining legal advice.

Unsatisfactory Information. While performing review procedures, the accountant may become aware of information that is incorrect, incomplete, or otherwise unsatisfactory. If this occurs, AR-C 90A.45 requires that the accountant ask management to consider the effect of those matters on the financial statements and to communicate the results of their consideration to the accountant. The accountant should then consider whether management's findings indicate the financial statements could be materially misstated (AR-C 90.45). To form a conclusion about whether the financial statements are materially misstated, the accountant evaluates whether sufficient appropriate review evidence has been obtained. 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 90A.47) According to AR-C 90A.48, the accountant should withdraw from the engagement if unable to obtain sufficient appropriate review evidence to form a conclusion.

Review Engagement Checklists and Practice Aids. Exhibit 2-3 lists the checklists and practice aids developed by the authors of *PPC's Guide to Cash, Tax, and Other Bases of Accounting* for a typical review of special purpose financial statements. Although not required by the authoritative literature, they are designed to assist practitioners in complying with the applicable performance and reporting requirements. These checklists and practice aids have been adapted from *PPC's Guide to Compilation and Review Engagements*.

Exhibit 2-3 presents guidelines for using the checklists contained in *PPC's Guide to Cash, Tax, and Other Bases of Accounting* to design a system of quality control that addresses the review engagement performance and client/engagement acceptance and continuance requirements of QC 10. The other quality control elements are discussed in *PPC's Guide to Quality Control* (GQC) and *PPC's Guide to Quality Control—Compilation and Review* (GCR). In addition, the "Engagement Performance Bridging Document with QCM Described—Compilations and Reviews" ties the requirements of QC 10 to the practice aids in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*.

Exhibit 2-3

Review Practice Aids

1. Engagement Letter for Review and Financial Statement Preparation of Special Purpose Framework Financial Statements
2. Engagement Acceptance and Continuance Form for Special Purpose Framework Engagements
3. Client Information Form for Special Purpose Framework Engagements
4. Review Procedures, Review, and Approval Form for Special Purpose Framework Engagements
5. Financial Statement Materiality Worksheet for Planning Purposes in a Review Engagement
6. Inquiry and Analytical Procedures Program for Cash Basis Financial Statements
7. Inquiry and Analytical Procedures Program for Income Tax Basis Financial Statements
8. Analytical Procedures Documentation Form
9. Review Reporting Checklist for Special Purpose Framework Engagements
10. Representation Letter for a Review of Special Purpose Framework Financial Statements
11. Disclosure Checklist for Cash Basis Financial Statements
12. Disclosure Checklist for Income Tax Basis Financial Statements
13. Journal Entry Approval Form
14. Engagement Independence Compliance and Nonattest Services Documentation Form
15. Accounting and Engagement Issues

The "Review Procedures, Review, and Approval Form for Special Purpose Framework Engagements," the "Inquiry and Analytical Procedures Programs," and the "Review Reporting Checklists for Special Purpose Framework Engagements" are discussed in the following paragraphs.Representation letters are discussed later in this lesson.

Review Procedures, Review, and Approval Form for Special Purpose Framework Engagements. The "Review Procedures, Review, and Approval Form for Special Purpose Framework Engagements" primarily addresses the areas of acceptance and continuance, independence, step-down considerations, obtaining a written communication with the client, designing review procedures, and performing inquiry and analytical procedures. The form does not duplicate provisions of the other practice aids suggested for review engagements. Instead, this form addresses the specific requirements of AR-C 90A. The staff person in charge of the review engagement generally should complete the review procedures section of the form. The partner review section of the form should be completed by the engagement partner. Completion of the engagement quality control review section is required only at the engagement partner's option or if the firm's quality control policies and procedures require it. If an engagement quality control review is performed, the engagement quality control review should be completed before the report is released. The engagement quality control reviewer should not be a member of the engagement team. The authors recommend that this checklist be completed on all review engagements (interim as well as year end) regardless of the size of the accounting firm.

The accountant should 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.

A firm's engagement checklists should interface with its QC document so that the necessary documentation needed for peer reviews is properly included in the engagement workpapers. Accordingly, the "Review Procedures, Review, and Approval Form for Special Purpose Framework Engagements" contains the steps needed to meet peer review requirements. The authors strongly recommend that practitioners who use the review checklists in *PPC's Guide to Cash, Tax, and Other Bases of Accounting* also follow the suggested QC policies found in *PPC's Guide to Quality Control* or *PPC's Guide to Quality Control—Compilation and Review*. [Call (800) 431-9025 or go to **tax.thomsonreuters.com** for order information.]

Financial Statement Materiality Worksheet for Planning Purposes in a Review Engagement. (AR-C 90A.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. Using the recent pandemic as an example, because the financial information needs of users may have changed due to COVID-19, the practitioner would consider whether benchmarks and related percentages used for materiality in reviews are affected. Significant reduction in operations and profitability due to travel restrictions and stay-at-home orders may mean that liquidity and solvency matters are more relevant to users' needs. Balance sheet benchmarks may be more reliable and predictive than income statement metrics and more significant to users' decision making. However, if the accountant believes income statement benchmarks would be more appropriate, normalized benchmark amounts based on the client's performance in past periods may be appropriate. The "Financial Statement Materiality Worksheet for Planning Purposes in a Review Engagement" can be used to document materiality.

Inquiry and Analytical Procedures Program. The "Inquiry and Analytical Procedures Program for Cash Basis Financial Statements" and the "Inquiry and Analytical Procedures Program for Income Tax Basis Financial Statements" are step-by-step checklists of the inquiries and analyses that should normally be performed on a typical review engagement when the financial statements are prepared on the cash or income tax basis of accounting. Although completion of this checklist is not required to meet SSARS or peer review requirements, the authors strongly recommend that it be completed for all review engagements, regardless of the size of the accounting firm, because it provides detailed guidance not found in other checklists. The "Inquiry and Analytical Procedures Program" is designed for the typical commercial entity and can be tailored to fit individual clients or industries.

Review Reporting Checklist for Special Purpose Framework Engagements. This checklist is designed to document the reporting considerations required by AR-C 90A. It presents common reporting requirements for reviewed special purpose framework financial statements. It should be emphasized, however, that the checklist cannot be a substitute for an accountant's exercise of professional judgment and knowledge of the SSARS.

SELF-STUDY QUIZ

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

16. Assuming all other conditions are met, when would reviews of interim financial statements be performed under AU-C 930 instead of the SSARS?

    a. The entity's most recent set of annual financial statements was compiled.

    b. The practitioner is engaged to address the interim financial statements but not the annual financial statements.

    c. The entity prepares its annual financial statements and its interim financial information using the same financial reporting framework.

    d. The accountant is engaged to prepare the interim financial statements but not to issue a report on that information.

17. Which of the following statements best describes the use of professional liability insurance?

    a. Firms can prevent liability from claims by having professional liability insurance.

    b. Insurers are legally obligated to impose the same quality control standards on those they insure.

    c. Typical professional liability insurance policies will cover claims based on erroneous investment advice and fraud.

    d. Professional liability insurance may not cover the full extent of claims against the firm.

18. The CPA firm of Singer, Tran, & Bradbury has three partners and five other professionals who have passed their Uniform CPA Exams and met the experience requirement of their state board. How many licenses does this firm need?

    a. One firm license.

    b. Two licenses, including a firm license.

    c. Eight licenses, one for each professional CPA.

    d. Nine licenses, including a firm license.

19. Accountants should do which of the following when compiling financial statements?

    a. Establish an oral agreement with the client about the services to be performed during the engagement.

    b. Have, or obtain, an understanding of the applicable financial reporting framework and significant accounting policies.

    c. Determine an appropriate materiality level for the financial statements as a whole.

    d. Perform appropriate inquiry, analytical, and other procedures to obtain evidence for the compilation report.

20. When performing review engagements, which of the following provide a basis for inquiries about relationships and individual items that appear to be unusual and that may indicate material misstatements?

    a. Analytical procedures.

    b. Checklists.

    c. Expectations.

    d. Corroboration of management's responses.

21. Which of the following guidance applies when communicating significant matters to management or those charged with governance in a review engagement?

    a. Communication to management about the accountant's views on disclosures must be in writing.

    b. The accountant must document communications with management concerning fraud in writing.

    c. Communications with management or those charged with governance are limited to four specific subjects.

    d. Such communications are required to take place at the end of the review, after all fieldwork is complete.

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.)**

16. Assuming all other conditions are met, when would reviews of interim financial statements be performed under AU-C 930 instead of the SSARS? **(Page 50)**

    a. The entity's most recent set of annual financial statements was compiled. [This answer is incorrect. According to AR-C 90A.02, one condition that indicates reviews of interim financial information are performed under AU-C 930 instead of the SSARS is that the entity's latest financial statements were *audited* (not compiled) by the accountant or a predecessor.]

    b. The practitioner is engaged to address the interim financial statements but not the annual financial statements. [This answer is incorrect. If certain conditions are met, reviews of interim financial information are performed under AU-C 920 instead of the SSARS. One such condition is that the accountant has been engaged to audit the entity's current year financial statements or when it is expected that the current year financial statements will be audited, the appointment of another accountant to audit the current year financial statements is not effective prior to the period covered by the review. If it is known in advance that the practitioner will not audit the annual financial statements prior to the time of the review, then this condition has not been met.]

    c. **The entity prepares its annual financial statements and its interim financial information using the same financial reporting framework. [This answer is correct. In accordance with AR-C 90A.02, the SSARS are not applicable to reviews of interim financial information if all of three conditions are met. One such condition is that the entity prepares its interim financial information using the same financial reporting framework as that used to prepare its annual financial statements. If this is the case and the other two conditions are met, then the accountant should perform the interim review in accordance with AU-C 930, *Interim Financial Information*.]**

    d. The accountant is engaged to prepare the interim financial statements but not to issue a report on that information. [This answer is incorrect. AR-C 70A allows accountants to prepare financial statements without issuing a report and does not limit the distribution of those statements. However, a financial statement preparation engagement is different from a review of interim financial information; therefore, this is not one of the conditions that must be met for AU-C 930 to apply to a review of interim financial information.]

17. Which of the following statements best describes the use of professional liability insurance? **(Page 52)**

    a. Firms can prevent liability from claims by having 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 protection of a professional's assets and *not* a means to prevent liability.]

    b. Insurers are legally obligated to impose the same quality control standards on those they insure. [This answer is incorrect. All professional liability insurers impose *their own* standards of quality control and implementation of quality control measures on their insured professionals.]

    c. Typical professional liability insurance policies will cover claims based on erroneous investment advice and fraud. [This answer is incorrect. It is not clear that every insurer will provide coverage for all claims that may arise out of the wide variety of services 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.]

    d. **Professional liability insurance may not cover the full extent of claims against the firm. [This answer is correct. Firms that 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.]

18. The CPA firm of Singer, Tran, & Bradbury has three partners and five other professionals who have passed their Uniform CPA Exams and met the experience requirement of their state board. How many licenses does this firm need? **(Page 55)**

    a. One firm license. [This answer is incorrect. Most states require firms to possess a firm (also known as a practice unit) license. Therefore, it is likely that Singer, Tran, & Bradbury will need this license, but the firm must consider other licensing requirements, as well.]

    b. Two licenses, including a firm license. [This answer is incorrect. If Singer (or one of the other partners) were operating as a sole practitioner, he would need two licenses—an individual license and a firm license. Since that is not the case in this scenario, this answer choice does not apply.]

    c. Eight licenses, one for each professional CPA. [This answer is incorrect. All eight CPAs at this firm will need individual licenses; however, other licensing requirements must also be taken into consideration.]

    d. **Nine licenses, including a firm license. [This answer is correct. In all firms other than sole practitioners, in addition to 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. Therefore, Singer, Tran, & Bradbury needs eight individual CPA licenses and one firm license.]**

19. Accountants should do which of the following when compiling financial statements? **(Page 55)**

    a. Establish an oral agreement with the client about the services to be performed during the engagement. [This answer is incorrect. AR-C 80A.10 requires practitioners to establish an understanding with the entity regarding the services to be performed and document the understanding through a *written* communication with management. AR-C 80A.11 also requires that the engagement letter be signed by both the accountant or the accountant's firm and management or those charged with governance.]

    b. **Have, or obtain, an understanding of the applicable financial reporting framework and significant accounting policies. [This answer is correct. AR-C 80A.12 requires practitioners to have, or obtain, an understanding of the applicable financial reporting framework and the significant accounting policies to be used in the preparation of the financial statement. This understanding is generally obtained throughout the engagement and through experience with the client or its industry.]**

    c. Determine an appropriate materiality level for the financial statements as a whole. [This answer is incorrect. AR-C 90A.19–.20 requires practitioners to determine materiality when performing a *review* engagement. This requirement is not applicable to compilation engagements, which are covered by AR-C 80A.]

    d. Perform appropriate inquiry, analytical, and other procedures to obtain evidence for the compilation report. [This answer is incorrect. AR-C 90A.26–.30 requires practitioners to perform appropriate inquiry, analytical, and other procedures during a *review* engagement. This does not apply to compilation engagements based on the requirements for such engagements in AR-C 80A.]

20. When performing review engagements, which of the following provide a basis for inquiries about relationships and individual items that appear to be unusual and that may indicate material misstatements? **(Page 62)**

    a. **Analytical procedures. [This answer is correct. The accountant should apply analytical procedures to the financial statements to identify and provide a basis for inquiries about relationships and individual items that appear to be unusual and that may indicate a material**

misstatement. 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 assurance given in the accountant's review report.]

b. Checklists. [This answer is incorrect. Checklists and practice aids, such as the ones available in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*, are not required by authoritative literature. However, they are designed to assist practitioners in complying with the applicable performance and reporting requirements.]

c. Expectations. [This answer is incorrect. AR-C 90A.27c requires the accountant to develop expectations as part of performing analytical procedures. 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. However, expectations alone will not provide the basis described above, so there is a better answer choice.]

d. Corroboration of management's responses. [This answer is incorrect. While accountants should consider the reasonableness of management's responses based on the results of other review procedures and the accountants' knowledge of the entity's business, accountants are not required to corroborate management's responses.]

21. Which of the following guidance applies when communicating significant matters to management or those charged with governance in a review engagement? **(Page 66)**

a. Communication to management about the accountant's views on disclosures must be in writing. [This answer is incorrect. According to AR-C 90A, most communications regarding significant matters that arise during engagement procedures may be written *or* oral.]

b. **The accountant must document communications with management concerning fraud in writing. [This answer is correct. AR-C 90A.118 requires the accountant to document *in writing* any 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.]**

c. Communications with management or those charged with governance are limited to four specific subjects. [This answer is incorrect. AR-C 90A.18 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 significant findings from the performance of review procedures, including findings that caused the accountant to consider or perform additional procedures and matters that led to modifying the accountant's review report, among other things. However, such communications are not limited and can cover other topics as the accountant deems necessary.]

d. Such communications are required to take place at the end of the review, after all fieldwork is complete. [This answer is incorrect. 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.]

THE USE OF ENGAGEMENT LETTERS

For audit engagements, AU-C 210A requires the auditor to establish an understanding with the client about the services to be performed and to document that understanding through an engagement letter or other written communication with the client. The issuance of an engagement letter may reduce the business risk to the auditor by clarifying the responsibilities of each party and the objectives and limitations of the engagement. The discussion on audit engagement letters later in this lesson primarily covers the aspects of those engagement letters that are unique for engagements of special purpose financial statements. *PPC's Guide to Audits of Nonpublic Companies* provides detailed guidance regarding audit engagement letters.

The SSARS also require the accountant to establish and document an understanding with client management or those charged with governance regarding the services to be performed for all reviews, compilations, and preparations of financial statements. The SSARS require such documentation to be in the form of an engagement letter or some other suitable form of written agreement (such as a contract). An oral understanding is not sufficient. The overriding reason to use an engagement letter is to fulfill the authoritative requirements previously mentioned. However, engagement letters help to avoid misunderstandings with the client and the disagreements and disputes that such misunderstandings can cause.

The following paragraphs discuss preparing engagement letters for compilation and review engagements for special purpose financial statements. *PPC's Guide to Compilation and Review Engagements* provides additional general guidance regarding SSARS engagement letters.

Informing Audit and SSARS 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. Also, firms may outsource portions of audit engagements. 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 requires a contractual agreement between the accounting firm and the service provider to maintain the confidentiality of the client information. The contractual agreement should provide the accounting firm 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. If the practitioner chooses to provide written disclosure that a third-party service provider will be used, this information can be included in the engagement letter.

Acceptance and Continuance Considerations

Before issuing an engagement letter, the firm should make a conscious decision as to whether to accept a new client relationship or engagement or continue with one previously established or performed. In conjunction with the firm's system of quality control, QM 10A requires CPA firms to establish policies and procedures for the acceptance and continuance of client relationships and specific engagements. According to QM 10A.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.

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, QM 10A requires that the firm document how the issues were resolved. The optional practice aids in *PPC's Guide to Cash, Tax, and Other Bases of Accounting* can be used to document acceptance and continuance considerations, including any significant issues discovered in the process.

SSARS Requirements for Acceptance and Continuance. In addition to the acceptance and continuance requirements of QM 10A, at an engagement level, the SSARS have requirements. AR-C 60A.25–.26 provide guidance in the form of preconditions related to the accountant's responsibility with regard to the acceptance or continuance of client relationships and engagements performed under the SSARS. AR-C 60A.A48 indicates that considerations related to client acceptance and continuance and compliance with relevant ethical requirements occur throughout the engagement as 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. When performing a review engagement, if, after the engagement is accepted, the accountant is not satisfied that preconditions at AR-C 60A.26 or AR-C 90A.13 have been met, the accountant should discuss the matter with management to determine (1) whether the matter can be resolved, (2) whether it is appropriate to continue the engagement, and (3) whether and how to communicate the matter in the accountant's report. (AR-C 90A.15)

The SSARS provide additional preconditions for accepting a special purpose framework compilation or review engagement, as discussed later in this lesson.

Audit Requirements for Acceptance and Continuance. Similar to the SSARS, the auditing standards include acceptance and continuance requirements specific to audit engagements. The requirements address the timing of when acceptance and continuance procedures should be performed, preconditions that should be met in the performance of an audit, and communicating with previous auditors. Of course, the acceptance and continuance requirements of QM 10A discussed prevoiously should also be followed. A more in-depth discussion of acceptance and continuance decisions in an auditing engagement is beyond the scope of this course, but further information is available in *PPC's Guide to Audits of Nonpublic Companies*.

The auditing standards include preconditions for accepting a special purpose framework audit engagement, as discussed later in this lesson.

Financial Statement Titles

A difference between an engagement letter for GAAP financial statements and an engagement letter for special purpose financial statements is that the financial statements referred to in the engagement letter should be titled using terms that do not imply financial presentations in conformity with GAAP. That difference applies to all types of engagements: compilations, reviews, and audits.

Compilation and Review Engagement Letters

Compilation. AR-C 80A.10–.11 require 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.

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.

As previously discussed, AR-C 60A.25–.26 establish general preconditions for accepting a SSARS engagement. AR-C 80A.08 provides additional preconditions in a compilation engagement if the financial statements are prepared using a special purpose framework. In that situation, the accountant should obtain the acknowledgment and understanding of management's responsibility to include—

- A description of the special purpose framework, including a summary of significant accounting policies, and how the framework differs from GAAP (the effects of which need not be quantified).
- Disclosures similar to those required by GAAP when the special purpose financial statements include items that are the same as, or similar to, those included in GAAP financial statements.
- A description of any significant interpretations of the contract on which the financial statements are based if the special purpose framework is the contractual basis of accounting.
- Additional disclosures beyond those specifically required by the framework that may be necessary for the financial statements to achieve fair presentation.

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 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 was discussed earlier in this lesson.

Review. AR-C 90A.16–.17 require the accountant to obtain a written agreement with the client regarding the services to be performed. The understanding with the client should be signed by both the accountant or the accountant's firm and management or those charged with governance, and should include the following:

- The objectives of the engagement.
- The responsibilities of management, including management's responsibilities for—
  - the selection of the 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.

The requirement that SSARS engagement letters be signed by both parties is more extensive than the requirement for audit engagement letters. Nevertheless, obtaining a written agreement with the client prior to the engagement is considered a best practice for audits.

As previously discussed, AR-C 60A.25–.26 establish general preconditions for accepting a SSARS engagement. AR-C 90A.13 a provides additional preconditions in a review engagement if the financial statements are prepared using a special purpose framework. In that situation, the accountant should obtain the acknowledgment and understanding of management's responsibility to include—

- A description of the special purpose framework, including a summary of significant accounting policies, and how the framework differs from GAAP (the effects of which need not be quantified).
- Disclosures similar to those required by GAAP when the special purpose financial statements include items that are the same as, or similar to, those included in GAAP financial statements.
- A description of any significant interpretations of the contract on which the financial statements are based if the special purpose framework is the contractual basis of accounting.
- Additional disclosures beyond those specifically required by the framework that may be necessary for the financial statements to achieve fair presentation.

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 70A. However, the accountant is required to comply with the requirements of ET 1.295. ET 1.295 was discussed earlier in this lesson.

Audit Engagement Letters

AU-C 210A.10 requires the auditor to obtain an engagement letter or other suitable form of written agreement with the client regarding the services to be performed. The engagement letter or other suitable form of written agreement should include the following:

- The objective and scope of the engagement.
- Management's responsibilities.
- The auditor's responsibilities.
- A statement that due to the inherent limitations of an audit, combined with the inherent limitations of internal control, there is a risk that a material misstatement may not be detected.
- Identification of the applicable financial reporting framework.
- Reference to the expected form and content of reports to be issued by the auditor and a statement that circumstances may occur in which a report may differ from its expected form and content.

When the financial reporting framework used for the preparation of the financial statements is a special purpose framework, the auditor is required by AU-C 800.10 to obtain an understanding of (a) the purpose of the financial statements, (b) the intended users, and (c) the steps management has taken to determine that the financial reporting framework used is acceptable in the circumstances. Once the auditor obtains an understanding of those matters, he or she can better determine whether the financial reporting framework is acceptable. Lesson 1provided additional information about determining the acceptability of the financial reporting framework.

AU-C 210A.06 establishes preconditions for an audit. AU-C 800.11 provides further explanation of the preconditions that apply to the audit of special purpose financial statements, indicating that the auditor is required to obtain management's acknowledgment and understanding of its responsibility to include all informative disclosures that are appropriate for the special purpose framework used to prepare the entity's financial statements. Those disclosures should include—

- A description of the special purpose framework, including a summary of significant accounting policies and how the framework differs from GAAP (the effects of which need not be quantified).
- Disclosures similar to those required by GAAP when the special purpose financial statements include items that are the same as, or similar to, those included in GAAP financial statements.

- Additional disclosures beyond those specifically required by the framework that may be necessary for the financial statements to achieve fair presentation.
- When the special purpose framework is the contractual basis of accounting, a description of any significant interpretations of the contract on which the financial statements are based.

The auditor is specifically precluded from accepting the engagement if management does not acknowledge its responsibilities. As previously mentioned, management's responsibilities are included in the engagement letter.

Addressing the Engagement Letter

AR-C 70A.10, AR-C 80A.10, AR-C 90A.16, and AU-C 210A.09 all state that the practitioner should agree on the terms of the engagement with management or those charged with governance. Additionally, AR-C 70A.A10, AR-C 80A.A12, AR-C 90A.A25, and AU-C 210A.A21 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 practitioner is still required to obtain management's agreement that it acknowledges and understands its responsibilities, as listed in AR-C 60A.26b and AU-C 210A.06. Consequently, the authors recommend the engagement letter not be only addressed to those charged with governance.

THE USE OF MANAGEMENT REPRESENTATION LETTERS

While a management representation letter is usually prepared by the practitioner, it is a communication from the client to the practitioner and is signed by client management. AU-C 580.21 specifically requires that written representations be obtained in the form of a representation letter addressed to the auditor. AR-C 90A.59 requires that written representations be requested from current management (or the owner or others) who have appropriate responsibilities for the financial statements and knowledge of the matters concerned. Authoritative literature is clear that the practitioner should obtain written representation from management when he or she audits or reviews financial statements. (No such requirement exists for compilation or financial statement preparation engagements.) The primary reasons for obtaining a management representation letter are—

a. Management is asked to acknowledge their responsibility for the financial statements. (In addition, management is asked to state their belief that the statements are fairly presented in conformity with the applicable financial reporting framework.) Even if the practitioner drafts or assists with drafting the financial statements and related notes, the financial statements are the responsibility of management and management must take responsibility for the fairness of the presentation.

b. To have management represent to significant matters that are important to the accountant's or auditor's opinion and to acknowledge and support the validity of results of other engagement procedures.

Representation Letters for Financial Statements Prepared in Conformity with a Special Purpose Framework

The most significant differences between representation letters for GAAP financial statements and representation letters for special purpose financial statements are as follows:

- The financial statements referred to in the representation letter will be titled using terms that do not imply financial presentations in conformity with GAAP.
- The reference to the basis of presentation will be to the applicable financial reporting framework (i.e., cash basis of accounting or income tax basis of accounting) rather than to GAAP.

The following paragraphs provide guidance on the preparation of management representation letters for review and audit engagements of special purpose financial statements. (Though outside the scope of this course, *PPC's Guide to Compilation and Review Engagements* and *PPC's Guide to Audits of Nonpublic Companies* provide general guidance for representation letters other than those specifically for engagements using special purpose financial statements.)

Authoritative Literature Covering SSARS Review 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 presentation of the financial statements. Additionally, when a client operates in a specialized industry, the accountant may modify the representation letter by including additional representations geared to those industries such as those contained in the *AICPA Audit and Accounting Guide* or PPC guide relating to the particular industry.

AR-C 90A.60 requires that, in connection with a review of financial statements, the management representation letter should indicate that management had fulfilled its responsibilities set out in the terms of the engagement and include 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 acknowledgment 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.
- That all transactions have been recorded and have been properly reflected in the financial statements.
- That management has provided all relevant information and access.
- Management's acknowledgment of full and truthful responses to all inquiries.
- 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.
- That management has disclosed to the accountant significant facts about any known allegations of fraud or suspected fraud affecting the entity involving management, employees, or others where the fraud could have a material effect on the financial statements.
- That 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.
- That 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.
- That management has disclosed to the accountant all information supporting the use of the going concern assumption in the financial statements.
- That subsequent events are properly disclosed and accounted for in 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 90A.60l 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, thus, generally there will be no uncorrected misstatements.
- Management has disclosed to the accountant all known actual or possible litigation and 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.

Dating the Review Representation Letter. AR-C 90A.60 indicates 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 because the accountant is concerned with events occurring up to the date of the accountant's review report.

Paragraph 1.193 of the AICPA Guide notes 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. The accountant would need to be in physical receipt of the letter prior to *release* of the review report.

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 Review 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 date of the last statement of assets, liabilities, and equity reported on by the predecessor require disclosure in or adjustment to such financial statements.

Authoritative Literature Covering Audit Representation Letters

AU-C 580, *Written Representations* indicates that an auditor should obtain written representations from management personnel who have appropriate responsibilities for the financial statements, as well as knowledge of the related matters. AU-C 580.10–.11 requires the auditor to request specific representations about management's responsibilities for (a) the preparation and fair presentation of the financial statements; (b) the design, implementation, and maintenance of internal control relevant to financial statements that are free of material misstatements due to error or fraud; (c) providing all relevant information and access; and (d) the completeness of transactions. The inability to obtain those written representations is a scope limitation that prevents the auditor from expressing an unmodified opinion. When those representations are either not provided by management, or the auditor cannot rely on the representations due to the auditor concluding that sufficient doubt exists about management's integrity, AU-C 580.25 requires the auditor to disclaim an opinion in accordance with AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*, or withdraw from the engagement.

AU-C 580 and other auditing standards require the auditor to request other written representations from management. In addition, the auditor may request other written representations that he or she considers appropriate in certain situations. AU-C 580.12–.18 requires the auditor to request management to provide specific written representations related to fraud, laws and regulations, uncorrected misstatements, litigation and claims, estimates, related-party transactions, and subsequent events. Management's refusal to provide representations required by these and other AU-C sections or any additional representations the auditor believes necessary in the circumstances is a scope limitation, which is sufficient to preclude the issuance of an unmodified opinion and may cause the auditor to disclaim an opinion or withdraw from the engagement.

Uncorrected Misstatements. AU-C 580.14 requires an acknowledgment in the representation letter that management has considered whether the effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. Uncorrected misstatements communicated in the representation letter include both misstatements identified by the auditor and misstatements brought to the auditor's attention

by management. A summary of the uncorrected misstatements should be included in or attached to the representation letter.

Dating the Audit Representation Letter. The auditor is concerned with matters occurring through the date of his or her report, not merely through the date of the statement of financial position. As a result, the representation letter should be dated as of the date of the auditor's report. AU-C 580.A27 indicates that the auditor does not need to physically possess management's representation letter on the date of the auditor's report. The requirement can be met if on or before the date of the auditor's report, management has received the final representation letter and confirmed to the auditor that they will sign the letter without exception. The auditor will need to physically possess the signed letter before releasing the audit report. Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unmodified opinion and may cause an auditor to disclaim or withdraw.

Periods Covered by the Letter. Written representations are required from management who has responsibility for the financial statements and knowledge of the matters concerned for all financial statements and periods covered by the audit or review report. Even when current management was not present during all periods referred to in the report, current management's responsibilities for the financial statements as a whole are not diminished and the requirement for the practitioner to request from them written representations that cover all the relevant periods still applies. For example, if the practitioner is reporting on comparative financial statements, the representation letter for the most recent engagement should address all periods being reported on. If senior management changed during or after the period under audit or review, the auditor still has to insist on written representations from current management.

SELF-STUDY QUIZ

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

22. A firm is most likely to outsource which of the following (possibly affecting the language used in the engagement letter)?

    a. Portions of a compilation engagement.

    b. Portions of a review engagement.

    c. A complete audit engagement.

    d. Tax services.

23. In the engagement letter for a review of special purpose financial statements, the accountant should obtain acknowledgment and understanding of management's responsibility to include which of the following in the financial statements?

    a. A description of areas in the special purpose framework that are treated the same as in GAAP.

    b. Disclosures similar to those required by GAAP if items are included that are the same as or similar to those included in GAAP financial statements.

    c. A statement that no additional disclosures have been included in the financial statements being reviewed.

    d. If the contractual basis is used, a copy of any contract upon which the financial statements are based.

24. Which of the following statements most accurately describes a management representation letter?

    a. It is typically prepared by the client.

    b. It is required in engagements involving special purpose financial statements.

    c. If a special purpose framework is used, the letter must refer to the financial statements using different titles.

    d. It can be replaced with documentation of an oral conversation in certain specific circumstances.

SELF-STUDY ANSWERS

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

22. A firm is most likely to outsource which of the following (possibly affecting the language used in the engagement letter)? **(Page 76)**

    a. Portions of a compilation engagement. [This answer is incorrect. It is rare for accounting firms to outsource portions of a compilation engagement; therefore, there is a better answer choice.]

    b. Portions of a review engagement. [This answer is incorrect. It is considered rare for accounting firms to outsource portions of a review engagement. A better, more common answer is available.]

    c. A complete audit engagement. [This answer is incorrect. Firms may outsource *portions* of audit engagements, but not the entire engagement.]

    d. **Tax services. [This answer is correct. Firms often will outsource 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.]**

23. In the engagement letter for a review of special purpose financial statements, the accountant should obtain acknowledgment and understanding of management's responsibility to include which of the following in the financial statements? **(Page 78)**

    a. A description of areas in the special purpose framework that are treated the same as in GAAP. [This answer is incorrect. According to AR-C 90A.13, under these circumstances, acknowledgment and understanding are needed of management's responsibility to include a description of the special purpose framework, including a summary of significant accounting policies and how the framework differs from GAAP (the effects of which need not be quantified).]

    b. **Disclosures similar to those required by GAAP if items are included that are the same as or similar to those included in GAAP financial statements. [This answer is correct. AR-C 60A.25–.26 establish general preconditions for accepting a SSARS engagement. AR-C 90A.13 provides additional preconditions in a review engagement if the financial statements are prepared using a special purpose framework. In that situation, the accountant should obtain the acknowledgment and understanding of management's responsibility to include, among other things, disclosures similar to those required by GAAP when the special purpose financial statements include items that are the same as, or similar to, those included in GAAP financial statements.]**

    c. A statement that no additional disclosures have been included in the financial statements being reviewed. [This answer is incorrect. The accountant should obtain the acknowledgment and understanding of management's responsibility to include additional disclosures beyond those specifically required by the framework that may be necessary for the financial statements to achieve fair presentation.]

    d. If the contractual basis is used, a copy of any contract upon which the financial statements are based. [This answer is incorrect. When the special purpose framework is the contractual basis of accounting, the engagement letter for a review engagement should allow the auditor to obtain management's acknowledgment and understanding of its responsibility to include a description of any *significant interpretations* of the contract on which the financial statements are based (not the whole contract).]

24. Which of the following statements most accurately describes a management representation letter? **(Page 81)**

    a. It is typically prepared by the client. [This answer is incorrect. While a management representation letter is usually prepared by the *practitioner*, it is a communication from the client to the practitioner and is signed by client management.]

    b. It is required in engagements involving special purpose financial statements. [This answer is incorrect. Management representation letters are required in audit and review engagements, but not in compilation engagements. This requirement is based on the type of engagement and not whether the financial statements were prepared using a special purpose framework.]

    c. **If a special purpose framework is used, the letter must refer to the financial statements using different titles. [This answer is correct. One of the most significant differences between a representation letter for GAAP financial statements and a representation letter for special purpose financial statements is that the financial statements referred to in the representation letter will be titled using terms that do not imply financial presentations in conformity with GAAP.]**

    d. It can be replaced with documentation of an oral conversation in certain specific circumstances. [This answer is incorrect. AU-C 580.21 specifically requires that written representations be obtained in the form of a representation letter addressed to the auditor. AR-C 90A.59 requires that written representations be requested from current management (or the owner or others) who have appropriate responsibilities for the financial statements and knowledge of the matters concerned. An oral conversation, even if documented, would not meet these requirements.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting—Course 1—Special Purpose Financial Statements and Related Engagement Considerations (OFSTG221)

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, fax, or mail 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
     OFSTG221 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 **October 31, 2023**. 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 Cash, Tax, and Other Bases of Accounting—Course 1—Special Purpose Financial Statements and Related Engagement Considerations (OFSTG221)

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 term does authoritative literature primarily use to refer to bases of accounting other than generally accepted accounting principles (GAAP)?

   a. Special purpose frameworks.

   b. Non-GAAP bases of accounting.

   c. Modified frameworks.

   d. Engagement-related frameworks.

2. IPLA Motors uses the cash basis of accounting. However, it makes some well-supported changes to this basis, including recording depreciation on fixed assets. What basis of accounting is IPLA using?

   a. The contractual basis.

   b. The modified cash basis.

   c. The pure cash basis.

   d. An other basis.

3. What alternative to GAAP provides greater flexibility for small businesses but still allows them to account for their transactions according to their economic substance?

   a. The AICPA's *Financial Reporting Framework for Small- and Medium-Sized Entities* (FRF for SMEs).

   b. The cash and the modified cash bases of accounting.

   c. The income tax basis of accounting.

   d. The regulatory basis of accounting.

4. Do practitioners involved with financial statements prepared using a special purpose framework need to be familiar with GAAP requirements?

   a. Yes, they need to list all the departures from GAAP in their report on the financial statements.

   b. Yes, GAAP disclosures are still required on the majority of entries in the special purpose financial statements.

   c. Yes, if the statements include items the same as or similar to those in GAAP statements, informative disclosures similar to GAAP disclosures are required.

   d. No, if the financial statements are prepared using a special purpose framework, familiarity with GAAP requirements is unnecessary.

5. According to AU-C 700, an auditor should do which of the following when forming an opinion and reporting on special purpose financial statements?

    a. Evaluate whether the financial statements have suitable titles.

    b. Quantify the effects of using a special purpose framework instead of GAAP.

    c. Include an other-matter paragraph restricting the use of the report when financial statements prepared on the regulatory basis are intended for general use.

    d. Attach an appropriately worded separate report to all auditor's reports when a specific layout, form, or wording is prescribed.

6. Anna is engaged to review financial statements that were prepared using a financial reporting framework generally accepted in another country. Where will Anna find appropriate guidance for that type of engagement in the Statements on Standards for Accounting and Review Services (SSARS)?

    a. AR-C 60A.

    b. AR-C 80A.

    c. AR-C 100.

    d. AR-C 120.

7. Which of the following is an element of fair presentation of special purpose financial statements when performing a SSARS engagement?

    a. A note explaining why any applicable financial statement disclosures were omitted.

    b. A description of the financial reporting framework including how it differs from GAAP.

    c. A copy of a contract upon which contractual basis financial statements are prepared as supplementary information.

    d. Not including any disclosures other than those required by the special purpose framework.

8. What guidance sets forth the fundamental principles of professional ethics that should be followed in both SSARS and auditing engagements (e.g., integrity, objectivity, and due care)?

    a. The AICPA *Code of Professional Conduct* (the Code).

    b. The AICPA Peer Review Standards.

    c. The AICPA Quality Control Standards.

    d. The International Financial Reporting Standards.

9. What body has the AICPA designated to establish international reporting standards for both private and public entities?

    a. The AICPA Special Task Force on Standards Overload.

    b. The Financial Accounting Standards Board (FASB).

    c. The International Accounting Standards Board.

    d. The Private Company Council (PCC).

10. What recent Statement on Auditing Standards (SAS) provides requirements for the appointment and eligibility of engagement quality reviewers and the performance of engagement quality reviews that supersede those in SQCS No. 8?

    a. SAS No. 142.

    b. SAS No. 144.

    c. SAS No. 145.

    d. SAS No. 146.

11. The core series of AU-C references—the latest SAS issued, regardless of its effective date and the most recent literature—are indicated by what numbering style?

    a. AU-C XXX.

    b. AU-C AXXX.

    c. AU-C XXXA.

    d. AU-C XXXB.

12. SSARS No. 26 is effective for compilation and review engagements of financial statements for periods ending on or after what date?

    a. December 31, 2022.

    b. December 31, 2023.

    c. December 31, 2025.

    d. December 31, 2026.

13. According to *Accounting and Financial Reporting Guidelines for Cash- and Tax-Basis Financial Statements* (the AICPA Practice Aid), what is one characteristic that indicates entities are good candidates for cash basis or tax basis financial statements?

    a. The entity has numerous third-party financial statement users.

    b. The owners expect that the entity will be required to present GAAP statements in the future.

    c. The owners are primarily interested in the tax implications of transactions.

    d. Complying with GAAP provides many benefits for little cost.

14. Which of the following entities would be most likely to use special purpose financial statements?

    a. Bunker Manufacturing has an inventory.

    b. Wesson Brothers has outside investors.

    c. Singer & Mills is highly leveraged.

    d. Angel Enterprises was formed primarily for tax purposes.

15. What type of entity is most likely to use the pure cash basis of accounting?

    a. A manufacturer.

    b. A partnership.

    c. An insurance company.

    d. A civic venture such as a fair.

16. King & Company follows an agreement that requires unique financial reporting calculations. What special purpose framework would likely be the most helpful under these circumstances?

    a. The contractual basis of accounting.

    b. The pure cash basis of accounting.

    c. The regulatory basis of accounting.

    d. An other basis of accounting.

17. When are transactions recognized for tax basis financial statements?

    a. When cash is received or paid.

    b. When cash is received or paid, unless a modification is elected.

    c. When they would be recognized on the entity's tax return.

    d. When such transactions would be recognized under GAAP.

18. The AICPA quality control standards apply to which of the following?

    a. GAAP financial statements, but not special purpose financial statements.

    b. Special purpose financial statements, but not GAAP financial statements.

    c. Both GAAP and special purpose financial statements equally.

    d. Only financial statements that will be compiled or reviewed.

19. Statement on Quality Control Standards (SQCS) No. 8 (QM 10A), *A Firm's System of Quality Control*, establishes standards and provides guidance for a firm's quality control (QC) system in relation to which of the following?

    a. Its consulting practice.

    b. Its accounting and auditing practice.

    c. Its nonattest services.

    d. Its tax preparation practice.

20. Firms need to tailor their criteria for performing engagement quality control reviews (EQCRs) to do which of the following?

    a. Match criteria in the QC standards.

    b. Remain the same over time.

    c. Address lower risk engagements.

    d. Address higher risk engagements.

21. An engagement review, as performed under the Peer Review Standards, evaluates the adequacy of which of the following?

    a. A firm's system of quality control.

    b. A firm's quality control materials (QCM).

    c. Engagements submitted for review.

    d. Engagements selected for an EQCR.

22. When is the *Conceptual Framework for AICPA Independence Standards* used?

    a. Every time a practitioner must decide whether to accept a SSARS or auditing engagement.

    b. Any time an independence question or issue arises during the course of an attest engagement.

    c. Any time there are no independence interpretations that address a particular independence circumstance.

    d. Any time safeguards must be applied to reduce threats to independence to an acceptable level.

23. Which of the following is a safeguard that might be implemented *by the firm* (not by the profession, legislation, regulation, or the attest client) to address threats to independence?

    a. Rotating the senior personnel assigned to an attest engagement team.

    b. Keeping all work for an attest engagement in-house instead of engaging an outside firm.

    c. Establishing continuing education requirements on independence and ethics.

    d. Submitting the firm's quality control system to an external peer review.

24. Which of the following is one requirement that must be met for practitioners to retain their independence when performing nonattest services for attest clients?

    a. An oral understanding about the engagement should take place in a discussion prior to performance of nonattest services.

    b. The member should assume management responsibilities when necessary to complete the engagement.

    c. The client should document the suitability of the practitioner's skills, knowledge, and experience.

    d. The client must evaluate the adequacy and results of the services performed by the practitioner.

25. According to ET 1.295.143, what type of threat to independence, if any, occurs when practitioners provide hosting services (e.g., keeping data or records on behalf of the client or hosting the client's website) to attest clients?

    a. Hosting services can become a familiarity threat if it necessitates more time spent with the client.

    b. Hosting services can be a management participation threat due to internal control concerns.

    c. Hosting services can lead to a self-review threat in relation to information hosted.

    d. Hosting services are not considered a threat to independence.

26. The primary authoritative literature for compilation and review services includes all of the following **except**:

    a. The SASs.

    b. The SSARS.

    c. The SQCSs.

    d. The Code.

27. The SSARS can be described as which of the following?

    a. Client driven.

    b. Engagement driven.

    c. Firm driven.

    d. Profit driven.

28. As outlined in this course, what four defensive methods should firms consider using to help mitigate the risks of litigation?

    a. Having an attorney on retainer, regular EQCRs, professional liability insurance, and damage control.

    b. Management representation letters, engagement letters, professional liability insurance, and other protective measures.

    c. Quality control, professional liability insurance, other protective measures, and engagement letters.

    d. Quality control, professional liability insurance, management representation letters, and having an attorney on retainer.

29. What is *damage control*?

    a. Methods for limiting the types of clients and engagements a firm accepts, staying within the scope of engagements, and applying professional skepticism.

    b. Procedures that allow firms to respond quickly to threatened and actual liability claims and designate a response team to manage the internal process.

    c. Methods for insulating the assets of a firm and its owners in case defenses against liability fail and professional liability insurance does not cover them.

    d. Responsibilities taken on by accountants in relation to fraud and noncompliance with laws and regulations.

30. What is the correct term under the SSARS for an intentional act causing misstatement in the financial statements?

    a. Error.

    b. Fraud.

    c. Noncompliance.

    d. Violation.

31. Jessica is engaged to review her client's annual financial statements. While performing review procedures, she discovers information that may indicate a fraudulent act on the part of her client. Who makes the final determination of whether fraud has occurred?

    a. Jessica.

    b. Client management.

    c. The client's board of directors.

    d. A court of law.

32. Which of the following is an issue that firms may face in relation to licenses?

    a. The firm may have too many licenses and need to waive some.

    b. One firm license is enough to do business in every state.

    c. State licensing requirements are obsolete if they differ from those of the AICPA.

    d. Expert CPA testimony may be disallowed if testifying in a state in which they are not licensed.

33. An accountant who is engaged to review a client's financial statements under AR-C 90A should do which of the following?

    a. Establish an oral understanding with the client about services to be performed and document it in the workpapers.

    b. Depend on the client's knowledge of the accounting practices of the industry and use them to plan procedures.

    c. Read the financial statements and consider whether they conform to the applicable financial reporting framework based on information from review procedures.

    d. Perform the review without consulting reports from other accountants who worked on the financial statements to ensure there is no bias.

34. The review evidence accumulated by the accountant should be sufficient to provide what type of assurance that no material modifications are needed for the financial statements to be in conformity with the applicable financial reporting framework?

    a. No assurance.

    b. Limited assurance.

    c. Reasonable assurance.

    d. Complete assurance.

35. AR-C 90A.29 sets which of the following requirements for review engagement inquiries?

    a. Accountants can only make inquiries about the topics listed in AR-C 90A.

    b. The original list of inquiries cannot be adjusted once the engagement begins.

    c. Accountants must make inquiries about accounting estimates and related parties.

    d. Accountants are required to corroborate all of management's responses.

36. What is the main, overriding reason that firms should use engagement letters?

    a. To fulfill the requirements of AU-C 210A and the SSARS.

    b. To create a binding contract for the engagement.

    c. To eliminate all disputes and disagreements with the client.

    d. To increase business risk and profitability associated with a client.

37. Which of the following must be done prior to sending an engagement letter?

    a. The firm should make suggestions for how a problematic client can improve its integrity.

    b. The firm should determine which legal and ethical requirements can be disregarded during the engagement.

    c. The firm should make a conscious decision about accepting or continuing the engagement.

    d. The firm should perform compilation, review, or audit procedures.

38. According to the authoritative literature for compilation, review, and audit engagements, engagement letters should be addressed to whom?

    a. The firm in general.

    b. The client's legal counsel.

    c. The client's accounting department.

    d. Management, those charged with governance, or both.

39. For a review engagement, when should the management representation letter itself be dated?

    a. The date the engagement was accepted.

    b. The date the letter is presented and signed by the client.

    c. The date of the financial statements being reviewed.

    d. Prior to the date of the accountant's review report.

40. What period of time should be covered by the management representation letter for an audit engagement?

    a. All periods referred to in the report on the financial statements.

    b. All periods referred to in the report for which management was present.

    c. The time period covered by the most recent set of financial statements.

    d. The time period covered by the most recent set of financial statements plus two years.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting—Course 1—Special Purpose Financial Statements and Related Engagement Considerations (OFSTG221)

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: October 31, 2023

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting—Course 1—Special Purpose Financial Statements and Related Engagement Considerations (OFSTG221)

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?	○	○	○	○	○	○	○	○	○	○
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7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. ______________

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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? ________
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GLOSSARY

Attest engagement: An engagement that requires independence. They include audits, examinations, agreed-upon procedures engagements, reviews, and compilations.

Cash basis: A basis of accounting used by the reporting entity to record cash receipts and disbursements. It includes modifications of the cash basis having substantial support (e.g., recording depreciation on fixed assets), commonly known as the *modified cash basis*.

Contractual basis: A basis of accounting used by the entity to comply with an agreement between the entity and one or more third parties other than the practitioner.

Damage control: A type of loss prevention that considers ways of containing potential liability problems and thereby minimizing their impact. Damage control procedures focus on responding quickly to threatened and actual liability claims and designating a response team to manage the internal process.

Engagement letter: A written communication with the client that can be used to establish an understanding with the client about the services to be performed and to document that understanding. Issuing engagement letters can reduce the business risk to the auditor by clarifying the responsibilities of each party and the objectives and limitations of the engagement. Engagement letters are required by the SSARS for all reviews, compilations, and preparations of financial statements. Either an engagement letter or another written communication can be used for audit engagements, per AU-C 210.

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 reviews (EQCRs): Firms perform these reviews as part of their QC system. They are required to establish criteria for determining when an EQCR should be performed as part of their QC policies and procedures. The structure and nature of the firm's practice are important to establishing such criteria, and the criteria should be tailored to address higher risk engagements.

Fraud: An intentional act that causes a misstatement in the financial statements.

Hosting services: Nonattest services that involve the AICPA member accepting responsibility for (1) being the sole host of a financial or nonfinancial information system of an attest client; (2) 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; and (3) providing back-up services or other electronic security services for an attest client's data or records.

Management representation letters: Though usually prepared by the practitioner, these are communications from the client to the practitioner and are signed by client management. They are necessary when practitioners audit or review financial statements, and in them, management is asked to (1) acknowledge their responsibility for the financial statements and (2) represent significant matters that are important to the accountant's or auditor's opinion and to acknowledge and support the validity of results of other engagement procedures.

Noncompliance: Intentional or unintentional violations of laws or government regulations, excluding *fraud*.

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

Quality control materials (QCM): Work programs, checklists, sample confirmations and letters, and other practice aids that help ensure the firm's compliance with both authoritative literature and peer review standards.

Quality control (QC) system: The purpose of this type of system is to promote quality in performing accounting and auditing engagements. It should provide the firm with reasonable assurance that (1) the firm and its personnel are complying with professional standards and applicable legal and regulatory requirements and (2) reports issued by the firm are appropriate in the circumstances.

Regulatory basis: A basis of accounting used by the reporting entity to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (e.g., a basis of accounting that insurance companies use pursuant to the accounting policies prescribed or permitted by a state insurance commission).

Risk avoidance: Loss prevention techniques that focus on (1) limiting the types of clients and engagements the firm accepts, (2) staying within the scope of the engagement, and (3) applying professional skepticism throughout the engagement. These are among the protective measures firms can use to minimize the impact of claims or potential claims against the firm.

Safeguards: These are controls that mitigate or eliminate *threats to independence*. To be effective, they must eliminate the threat or reduce to an acceptable level the threat's potential to impair independence. The three broad categories of safeguards include those (1) created by the profession, legislation, or regulation; (2) implemented by the attest client; and (3) implemented by the firm.

Special purpose frameworks: Bases of accounting other than GAAP. They are a widely used alternative to the numerous and sometimes complex accounting requirements prescribed by GAAP. These are also known as *other comprehensive bases of accounting (OCBOAs).*

Tax basis: A basis of accounting the reporting entity uses to file its tax return for the period covered by the financial statements (also known as the *income tax basis*).

Threats to independence: Circumstances that could impair independence. Examples include the self-review threat (reviewing your own work, or that of your team, as part of the attest engagement), the advocacy threat (actions that promote an attest client's interests or position, such as representing a client in tax court).

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

COURSE 2

REPORTING ON SPECIAL PURPOSE FRAMEWORK FINANCIAL STATEMENTS AND SPECIAL ENTITIES (OFSTG222)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses reporting requirements for financial statements using special purpose frameworks, and unique issues encountered by certain types of special entities that use them. Lesson 1 discusses considerations for compilation and review reports, auditor's reports, as well as various other reporting situations. Lesson 2 examines special entities, such as nonprofit organizations and estates and trusts, and some of the specialized accounting and reporting issues related to their use of special purpose framework financial statements.
PUBLICATION/ REVISION DATE:	October 2022
RECOMMENDED FOR:	Users of *PPC's Guide to Cash, Tax, and Other Bases of Accounting*
PREREQUISITE/ ADVANCE PREPARATION:	Basic knowledge of accounting
CPE CREDIT:	8 NASBA Registry "QAS Self-Study" Hours This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.
FIELD OF STUDY:	Accounting
EXPIRATION DATE:	Postmark by **October 31, 2023**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Reporting on Special Purpose Framework Financial Statements

Completion of this lesson will enable you to:

- Identify required elements of compilation and review reports, how lack of independence affects reporting, financial statements that omit substantially all disclosures, material measurement departures, and using various emphasis paragraphs.
- Recognize how modifications are made to the auditor's standard reports.

- Identify other reporting situations, such as reporting on regulatory and contractual basis statements, use of Form 990 and prescribed forms, and preparing personal financial statements using various bases of accounting.

Lesson 2—Special Entities

Completion of this lesson will enable you to:
- Determine how use of a special purpose framework could affect financial statements of a nonprofit organization.
- Identify considerations for estates and trusts using special purpose framework financial statements.
- Recognize how individual personal financial statements may be affected when using a special purpose framework.
- Determine how financial statements of a professional service entity may be affected by using a special purpose framework.

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.

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Lesson 1: Reporting on Special Purpose Framework Financial Statements

INTRODUCTION

Practitioners have the same reporting alternatives for special purpose financial statements (such as cash, income tax, or regulatory basis financial statements) as they do for GAAP basis financial statements. That is, depending on the level of service provided, they issue compilation, review, or audit reports on the financial statements. The following sections discuss issues that should be considered when preparing compilation, review, or audit reports on special purpose financial statements. (Agreed-upon procedures and other attestation engagements are not discussed in this course but more information can be found in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*.) For further reporting guidance on compilations or reviews, refer to *PPC's Guide to Compilation and Review Engagements*. For additional reporting guidance on audit engagements, refer to *PPC's Guide to Auditor's Reports*.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify required elements of compilation and review reports, how lack of independence affects reporting, financial statements that omit substantially all disclosures, material measurement departures, and using various emphasis paragraphs.
- Recognize how modifications are made to the auditor's standard reports.
- Identify other reporting situations, such as reporting on regulatory and contractual basis statements, use of Form 990 and prescribed forms, and preparing personal financial statements using various bases of accounting.

General Reporting Considerations

General reporting considerations related to presentation of the report, such as report title, addressing the report, financial statement titles, firm signature, etc., are discussed later in this lesson. Following is a discussion on dating the report.

Report Date. The date of completion of the compilation should be used as the date of the accountant's report on compiled financial statements (AR-C 80A.17i). The authors believe that completion of a compilation generally occurs on the date the financial statements are *read*, as the term is used in AR-C 80A.13. As a practical matter, the date probably has little bearing on the accountants' legal liability in a compilation engagement.

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 90A.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 report (AR-C 90A.A99). 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.

The date of the auditor's report should not be earlier than the date when the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements (AU-C 700.43). The auditor cannot simply use the date that the audit team left the field unless the auditor has sufficient appropriate audit evidence at that date. In addition, AU-C 580.20 requires management representations to be made as of the date of the auditor's report.

CONSIDERATIONS FOR COMPILATION AND REVIEW REPORTS

Non-reporting Option

A non-reporting option is allowed under AR-C 70A, *Preparation of Financial Statements*. This course provides limited information about performing preparation engagements. Detailed information on performing preparation engagements can be found in *PPC's Guide to SSARS Preparation Engagements*.

Required Elements of Compilation Reports

AR-C 80A.17 requires a written report on compiled financial statements to—

a. Include a statement that the management is responsible for the financial statements.

b. Identify the financial statements that have been compiled.

c. Identify the entity whose financial statements have been compiled.

d. Specify the date or period covered by each financial statement.

e. Include a statement that the accountant performed the compilation engagement in accordance with SSARS issued by the Accounting and Review Services Committee of the AICPA.

f. Include a statement that the accountant has not audited or reviewed the financial statements, nor was required to perform any procedures to verify the accuracy or completeness of the information provided by management and, accordingly, does not express an opinion, a conclusion, or any assurance on the financial statements.

g. Include the signature of the accounting firm or the accountant.

h. Include the city and state where the accountant practices.

i. Include the date of the compilation report. The date of the accountant's report should be the date of the completion of the compilation procedures.

When reporting on compiled special purpose financial statements prepared, AR-C 80A.18–.21 has additional requirements for compilation reports, as explained below—

- The accountant should modify the compilation report when the financial statements do not include disclosure of the basis of presentation (including all of the items discussed in the "Disclosure of Basis of Accounting" paragraph later in this section) and disclosures similar to those required by GAAP when the financial statements include items that are the same as or similar to those in GAAP statements. If the compiled financial statements omit substantially all disclosures, then this requirement does not apply.
- The accountant should evaluate whether the financial statements prepared in accordance with the provisions of a contract adequately describe any significant interpretation of the contract upon which the financial statements are based and modify the compilation report if the financial statements do not adequately describe any such interpretations.
- The accountant's compilation report should make reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances when management has a choice of financial reporting frameworks.

- The accountant's compilation report should include a separate paragraph (a) indicating that the financial statements are prepared in accordance with the applicable special purpose framework; (b) referring to a note included in the financial statements that describes the framework (see the exception to this requirement for compilations explained later in this section); (c) stating that the special purpose framework is a basis of accounting other than GAAP; and (d) when the financial statements are prepared using a contractual basis of accounting, stating that the financial statements may not be suitable for another purpose.

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

Required Elements of Review Reports

AR-C 90A.76 requires a report on reviewed financial statements to—

a. Have a title that clearly indicates that it is the accountant's review report and includes the word *independent*. An appropriate title would be "Independent Accountant's Review Report."

b. Be addressed as appropriate 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 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 in accordance with SSARS issued by the Accounting and Review Services Committee of the AICPA;
   - A statement that those standards require the accountant to perform the review procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements for the financial statements to be in accordance with the applicable financial reporting framework; and
   - A statement that the accountant believes the results of the accountant's procedures provide a reasonable basis for the accountant's conclusion.
   - A statement that the accountant is required to (a) be independent of the entity, and (b) meet other professional ethical responsibilities as required to perform a SSARS review.

f. Includes 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. When the accountant's conclusion on the financial statements is modified (AR-C 90A.70):

  - 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 no earlier than the date that the accountant obtains sufficient appropriate review evidence to base his or her conclusion on the financial statements. 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, including the related notes.

When reporting on reviewed financial statements prepared using a special purpose framework, AR-C 90A.77–.81 has additional requirements for review reports, as explained below—

- The accountant should modify the review report when the financial statements do not include disclosure of the basis of presentation (including all of the items discussed in the "Disclosure of Basis of Accounting" paragraph later) and disclosures similar to those required by GAAP when the financial statements include items that are the same as or similar to GAAP statements.

- The accountant should evaluate whether the financial statements prepared in accordance with the provisions of a contract adequately describe any significant interpretation of the contract upon which the financial statements are based and modify the review report if the financial statements do not adequately describe any such significant interpretations.

- The accountant's review report should make reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances when management has a choice of financial reporting frameworks.

- The accountant's review report should include a separate emphasis-of-matter paragraph with an appropriate heading (a) indicating that the financial statements are prepared in accordance with the applicable special purpose framework; (b) referring to a note included in the financial statements that describes the framework; and (c) stating that the special purpose framework is a basis of accounting other than GAAP. For special purpose financial statements prepared in accordance with the contractual basis of accounting, the paragraph should state that the financial statements may not be suitable for another purpose.

- The accountant's review report should include an other-matter paragraph with an appropriate heading that restricts the use of the report when the financial statements are prepared in accordance with the contractual basis of accounting meeting the criteria listed at AR-C 90A.81. Restricting the use of the review report is discussed later in this section.

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

Modifications to Compilation and Review Reports

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

Lack of Independence. While accountants are precluded from issuing audit or review reports when they are not independent, independence is not required to issue compilation reports provided accountants comply with the compilation standards. When the accountant is not independent, the compilation report should specifically disclose that fact (AR-C 80A.22) by including the following as the last paragraph:

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

Some accountants add this paragraph as a conservative practice. Accountants who are extensively involved in providing various accounting and consulting services to a given client may conclude that they are not independent without analyzing each independence impairment for each compiled reporting period (for example, on a monthly or quarterly basis). These accountants need to consider the impact this approach could have on future engagements. A bank, bonding agent, or other third party may subsequently ask for reviewed financial statements at the end of the year, for which the accountant would be required to be independent. 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 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 must be disclosed.) To reduce the risk of litigation, the authors recommend that the accountant simply add the paragraph illustrated above without stating why independence is impaired. Because of the complexity of the independence rules, the accountant may disclose one reason for the lack of independence and overlook other independence impairments. This increases the liability risk to a user of the complied 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 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 31, 20XX, because I (a member of the engagement team) had a direct financial interest in XYZ Company.

b. I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because an immediate family member of one of the members of the engagement team was employed by XYZ Company.

c. I am (We are) not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because I (we) performed certain accounting services that impaired my (our) independence.

In making a decision about independence, the accountant should follow the AICPA *Code of Professional Conduct* (AR-C 80A.A8). One aspect of determining independence that is often overlooked is the effect of uncollected client fees. Additionally, when an AICPA member provides hosting services to an attest client (such as maintaining the attest client's fixed assets and depreciation schedules on behalf of the client), independence would be impaired and could not be reduced to an acceptable level by the application of safeguards.

Substantially All Disclosures Omitted. Compiled financial statements may omit substantially all disclosures provided the compilation report discloses the omission and the omission, in the accountants' professional judgment, would not mislead those who might reasonably be expected to use the financial statements. AR-C 80A.27 indicates that a separate paragraph should be added to the compilation report that includes specified elements. The following paragraph meets those requirements for a cash or tax basis compilation report—

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

When reporting on compiled financial statements prepared using a special purpose framework, AR-C 80A.21 requires, among other things, that the accountant's report refer to a note included in the financial statements that describes the framework. However, when compiled special purpose financial statements omit substantially all disclosures and the omission, in the accountant's professional judgement, would not mislead those who might reasonably be expected to use the financial statements, referring to a note that describes the special purpose framework would not be applicable. AR-C 80A.A31 indicates that such financial statements need not include a summary of significant accounting policies, nor a description about how the special purpose framework differs from GAAP. (The report would, however, still include a paragraph concerning the basis of accounting.)

The modification for compiled financial statements discussed above is not appropriate for reviewed financial statements because the omission of material disclosures is a departure from the applicable financial reporting framework and should be treated as such in the review report. (Guidance later in this section further discusses modifying compilation and review reports for departures from the applicable financial reporting framework.) Because of those requirements, accountants ordinarily would not accept an engagement to review financial statements that omit substantially all disclosures. An engagement to compile financial statements that omit substantially all disclosures may be accepted provided, in the accountant's professional judgement, such financial statements would not be misleading to those who will use the statements (AR-C 80A.26). Consequently, a client wishing to omit substantially all disclosures may prefer to have the accountant compile the financial statements rather than review them.

Only Selected Information Is Disclosed. If compiled financial statements disclose only selected information, the disclosures may be labeled "SELECTED INFORMATION—Substantially All Disclosures Ordinarily Included in the [Cash Basis OR Income Tax Basis] of Accounting Are Not Included," and a paragraph describing the omission of substantially all disclosures should be added to the compilation report as shown above. (As further discussed later in this section, an accountant, who in their professional judgment, believes the omission would mislead those who might reasonably be expected to use the financial statements should request that the financial statements be revised to include the omitted disclosures.)

In a compilation that omits substantially all disclosures, what constitutes *substantially*? AR-C 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 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 80A and AR-C 90A provide guidance for reporting on financial statements that include a departure from the applicable financial reporting framework in compiled and reviewed financial statements, respectively. A more detailed discussion on reporting on compiled and reviewed financial statements containing departures from the applicable reporting framework is provided below.

Disclosure of Basis of Accounting. AR-C 80A.18 and AR-C 90A.77 indicate that the accountant should modify his or her report when special purpose financial statements do not include a description of the special purpose framework, a summary of significant accounting policies, and an adequate description of how the special purpose framework differs from GAAP (excluding the exception provided for compiled financial statements that omit

substantially all disclosures). A note in the financial statements disclosing the basis of accounting might read as follows:

> NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
>
> Basis of Accounting
>
> The Company's policy is to prepare its financial statements on the cash basis of accounting; consequently, certain revenues are recognized when received rather than when earned, and certain expenses and purchases of assets are recognized when cash is disbursed rather than when the obligation is incurred.

Departures from the Applicable Financial Reporting Framework—Compilation Engagements. When an accountant becomes aware of material departures from the applicable financial reporting framework during a compilation engagement, there are three possible courses of action:

a. Persuade the client to revise the statements to conform with the applicable financial reporting framework.

b. Refer to the departure in the compilation report.

c. Withdraw from the engagement.

Obviously, revision of the statements (item a.) is the preferred course of action. If revision is not feasible, the accountant then determines whether to report on the departure or withdraw from the engagement (items b. and c.).

If modification of the accountant's report is appropriate, the nature of the departure from the applicable financial reporting framework should be disclosed in a separate paragraph, and the effects (dollar amount) of the departure should be disclosed, if known (AR-C 80A.30). 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 80A.31).

According to AR-C 80A.A42, an accountant cannot modify a compilation report to indicate that the financial statements are not fairly presented in conformity with the applicable financial reporting framework. An adverse opinion is not appropriate in a compilation engagement, but rather only in an audit or review engagement. However, according to Paragraph 2.78 of the AICPA Guide, the accountant may wish to emphasize the limitations of financial statements having significant departures (whether disclosure or measurement) in a separate other-matter paragraph in the report. The paragraph is in addition to a separate paragraph that describes the departure. In deciding whether to include such a paragraph, the accountant considers—

a. the possible dollar magnitude of the departures,

b. the significance of the affected items to the entity,

c. the pervasiveness and overall impact of the misstatement, and

d. whether the effects of the departure have been disclosed.

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

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

If the accountant does not believe that modification of the accountant's report is appropriate and the client refuses to revise the financial statements, the accountant should withdraw from the engagement and consider consulting legal counsel (AR-C 80A.32).

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

a. Persuade the client to revise the statements to conform with the applicable financial reporting framework.

b. Issue a qualified conclusion on the engagement.

c. Issue an adverse conclusion on the engagement.

d. Withdraw from the engagement.

Obviously, revision of the statements (item a. above) is the preferred course of action. If revision is not feasible, the accountant then determines whether to report on the departure or withdraw from the engagement (items b. through d. above).

AR-C 90A.71–.74 allows the accountant to express a *qualified conclusion* in a review report when the accountant has obtained sufficient appropriate review evidence and has determined or is aware through other means that the financial statements contain material misstatements that are not pervasive. The accountant should express an *adverse conclusion* when the financial statements are materially and pervasively misstated. The accountant should consider the following when reporting a qualified conclusion (AR-C 90A.74):

a. If the material misstatement relates to quantitative amounts in the financial statements (or quantitative disclosures) and the effects of the departure on the financial statements are known to the accountant or have been determined by management, describe and quantify the financial effects of the misstatement in the review report.

b. If the effects of the departure are not known to the accountant or have not been determined by management, the accountant is not required to determine the effects of the departure, but the accountant should state that such determination has not been made by management in the review report.

c. If the material misstatement relates to qualitative disclosures, explain how the disclosures are misstated.

d. If the material misstatement relates to the nondisclosure of information required to be disclosed, describe the nature of the omitted information. Furthermore, the accountant should include omitted disclosures when possible.

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

Reporting When Other Accountants Have Audited or Reviewed a Component. If other accountants are engaged to audit or review the financial statements of a division, branch, subsidiary, or other investees, the accountant is required to obtain and read the reports from the other accountants (AR-C 90A.40) 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. [There is also a requirement to perform procedures to be satisfied that the work performed by the other accountants is adequate if the accountant will use the work performed by the other accountants (AR-C 90A.39).] The accountant may decide to refer to the work of other accountants in his or her review report on the financial statements. (However, the SSARS do not provide guidance for referring to the work of other accountants who have compiled a portion of the financial statements since no assurances can be derived from compilation work.) If such a reference is made, the review report should indicate the magnitude of the portion of the financial statements reviewed or audited by the other accountants (AR-C 90A.122). The disclosure of the magnitude of the portion of the financial statements reviewed or audited 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 90A.123 indicates 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.

AR-C 90A.125 addresses referring to the other accountant's report when the financial reporting framework used in the component's financial statements is different than the reporting framework used in the reporting entity's financial statements and indicates that in such a situation, 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—

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.

Referencing the work of another accountant is often done to reduce the risk and effort of the primary accountant. The authors believe that the situation described in the paragraph above is not likely to occur in practice, primarily because it would be rare that the two different frameworks would be similar (that is, use similar criteria for measurement, recognition, etc.). However, even if the first requirement was satisfied (item a.), it may not make sense to exert the time and effort to satisfy the second requirement (item b.) because in a review engagement not much time will be saved by referencing someone else's work, and it may take almost as much time to satisfy the second requirement as it would to perform the review of the component.

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

a. Attempt to have the predecessor accountant *reissue* the report.

b. Make reference to the predecessor accountant's report in his or her own report.

c. Perform a compilation, review, or audit of the prior period financial statements and issue his or her own report.

Detailed guidance on reporting considerations when there is a change in accountants is provided in PPC's Guide to Compilation and Review Engagements.

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

a. The predecessor accountant can reissue his or her report. AR-C 80A, 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 predecessor accountants choose to perform certain procedures in making this determination.

b. The successor accountant can report on the financial statements for both periods. If the successor chooses this option and reports on the restated financial statements, the successor performs a compilation or review in accordance with AR-C 80A or 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.

c. An additional option is having the successor accountant report on the restatement adjustment only. In these reporting situations, the successor accountant indicates in an other-matter paragraph of the compilation or review report that a predecessor accountant reported on the financial statements of the prior period before restatement.

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 90A as they relate to review reports, but are not discussed in AR-C 80A. Paragraph 2.88 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 80A requires the use of *additional* paragraphs (not described as an emphasis-of-matter paragraph in AR-C 80A) in certain instances.

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. AR-C 80A does not discuss the use of other-matter paragraphs in compilation reports and Paragraph 2.88 of the AICPA Guide notes that their use is not prohibited. Also see below for a discussion of when additional paragraphs (not described as an other-matter paragraph in AR-C 80A) are required in a compilation report.

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 90A.93).

The accountant should include an additional (separate) 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 a separate paragraph (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 80A.22).

c. When substantially all disclosures are omitted, the compilation report should disclose the omission (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 a separate paragraph.

e. When supplementary information is included with the financial statements and the accountant's compilation report, the report should include a separate paragraph (AR-C 80A.34–.36).

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 90A.80).

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 90A.55c).

c. When the financial statements are prepared in accordance with a special purpose framework, the review report should include an other-matter paragraph that restricts the use of the accountant's review report when the financial statements are prepared in accordance with the contractual basis of accounting (AR-C 90A.81, AR-C 90A.103–.104, and AR-C 90A.A132). (While not a requirement, AR-C 90A.A132 also indicates that the accountant may consider it necessary in the circumstances of the engagement to include an alert that restricts the use of the accountant's report when the financial statements are prepared under a special purpose framework other than the contractual basis of accounting.)

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 90A.86).

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 90A.87).

f. When the accountant becomes aware of a material departure from the applicable financial reporting framework (including inadequate disclosure).

g. When supplementary information is included with the financial statements and the accountant's compilation or review report, the report should include an other-matter paragraph (AR-C 80A.34–.39 and AR-C 90A.126–.128).

h. 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, AR-C 90A.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." AR-C 80A does not require going concern to be specifically addressed in the compilation report.

i. When there are adjustments to correct a material misstatement in previously issued financial statements, the accountant's review report should include an emphasis-of-matter paragraph (AR-C 90A.94).

While accountants generally 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 accountants to choose the information pertaining to the financial statements that needs to be emphasized. The presumption is that all disclosures required in special purpose financial statements are important. Thus, choosing one matter to discuss could place undue emphasis on that matter and detract from other important disclosures. However, accountants may decide that an emphasis-of-matter paragraph is necessary to highlight an unusual or important matter that is disclosed in the financial statements, such as significant related party transactions or an unusually important subsequent event.

In addition to the 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.

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

When the accountant includes an emphasis-of-matter or other-matter paragraph, the paragraph should (AR-C 90A.90–.92)—

a. Be in a separate section of the accountant's report. In a review report, the section should include a heading titled "Emphasis of a Matter," "Other Matter," or other appropriate heading in the review report. In a compilation report, the use of headings is optional.

b. 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. (AR-C 90A.90b indicates that the emphasis-of-matter paragraph should refer only to matters presented or disclosed in the financial statements.)

c. 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.

The next several paragraphs address specific types of situations that may require the use of additional, emphasis-of-matter, or other-matter paragraphs.

Uncertainties about the Entity's Ability to Continue as a Going Concern. FASB ASC 205-40-50-1 requires management to evaluate whether conditions or events indicate there is substantial doubt about the entity's ability to continue as a going concern for the year subsequent to the date the financial statements are issued or the date the financial statements are available to be issued. Substantial doubt about an entity's ability to continue as a going concern exists when aggregate conditions and events indicate it is probable that the entity will not be able to meet its obligations as they are due during the year following the date the financial statements are available to be issued. The FASB guidance uses the term *probable*, which means likely to occur. Conditions indicating substantial doubt about the entity's ability to continue as a going concern may not be as evident in pure cash and modified cash basis financial statements as they are in financial statements prepared using generally accepted accounting principles. For example, a statement of cash receipts and disbursements prepared under the pure cash basis may reflect an increase in cash even though the entity has suffered recurring losses. The remainder of this discussion addresses the going concern consideration guidance provided by the SSARS.

AR-C 90A.08 defines *reasonable period of time* to be the period of time specified by the applicable financial reporting framework. FASB ASC 205-40 identifies a reasonable period of time to be one year after the financial statements are issued or available to be issued. If the applicable financial reporting framework does not contain such a requirement (as is the case with special purpose frameworks), AR-C 90A.08 uses the same time frame as FASB ASC 205-40 to define a reasonable period of time.

AR-C 90A.A179 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* that 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. The SSARS go on to state 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 situation when substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time is not alleviated is addressed below.

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 discussed earlier in this section should be followed.

<u>Review Reports.</u> After considering conditions or events and management's plans, the accountant may conclude that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains. If so, AR-C 90A.109 requires the accountant to include a separate section in the review report titled "Substantial Doubt

About the Entity's Ability to Continue as a Going Concern," which refers to the note in the financial statements that (a) discloses the identified conditions and events as well as management's plans regarding those conditions and events; and (b) discloses that the conditions and events indicate substantial doubt exists regarding the entity's ability to continue as a going concern for a reasonable period of time. The separate section in the review report also states that the accountant's conclusion is not modified with respect to substantial doubt regarding the entity's ability to continue as a going concern. AR-C 90A.110 indicates that the accountant should not use conditional language in the "Going Concern" section regarding 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, as further discussed below.

Compilation Reports. While accountants are not required to add an emphasis-of-matter paragraph regarding going concern to the standard compilation report, the authors recommend including an emphasis-of-matter paragraph in the accountant's compilation report if there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and the financial statements include disclosures. An example of such an emphasis-of-matter paragraph is presented below. Note that the compilation example does not use the phrase "substantial doubt" like the review report example below it. If the compiled financial statements omit substantially all disclosures, an option would be to add a selected disclosure to the compiled financial statements. Then the accountant could add an emphasis-of-matter paragraph to the compilation report.

> The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X, certain conditions indicate that the Company may be unable to continue as a going concern. The accompanying financial statements do not include any adjustments that might be necessary should the Company be unable to continue as a going concern.

Considering the Applicable Financial Reporting Framework. AR-C 90A.110 indicates that when it is appropriate to include a going concern section in the review report, the accountant should do so by using terms that are consistent with those included in the financial reporting framework used by the entity. For example, accountants should use language consistent with requirements under GAAP if the entity presents GAAP-based financial statements. Likewise, accountants should use language consistent with requirements under the appropriate special purpose framework if the entity presents its financial statements using a special purpose framework.

A going concern section in the review report would be included when the accountant concludes that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time and (a) the entity is *not* required under the applicable financial reporting framework (such as when preparing financial statements using the cash or tax basis of accounting) to include a statement in the notes to the financial statements that substantial doubt exists and (b) management's plans do not alleviate the substantial doubt. AR-C 90A.A176 provides an illustration for when the financial statements are GAAP basis and management's plans do not alleviate the substantial doubt. That guidance also notes that when a financial reporting framework other than GAAP is used, the illustrations at AR-C 90A.A176 may be adapted for the applicable financial reporting framework. If the illustration at AR-C 90A.A176 is adapted for a special purpose framework, the authors believe the wording would be as follows:

> **Going Concern**
>
> 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, certain conditions raise 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 these 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.

In the situation presented in the previous paragraph, management may choose to make a disclosure that states substantial doubt exists even though the applicable financial reporting framework does not require such a statement. Given that situation, the authors believe the illustrative going concern language provided in AR-C 90A.A176, Illustration 1, may be more appropriate because it refers to the statement made by management.

Additionally, if the entity uses a special purpose framework that requires management to include a statement in the notes to the financial statements that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time (such as when preparing financial statements using the AICPA's *Financial Reporting Framework for Small- and Medium-Sized Entities*), then the going concern emphasis-of-matter language provided in AR-C 90A.A176, Illustration 1 is the appropriate language to be used in the accountant's review report. (This course does not provide detailed information on the AICPA's *Financial Reporting Framework for Small- and Medium-Sized Entities.*)

COVID-19 Implication on Going Concern. The topic of going concern is especially relevant today, given the significant impact of COVID-19 on nonpublic businesses in 2021 and 2022, and likely beyond, and may result in numerous going concern issues in review and compilation engagements. 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 may 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 have experienced negative impacts that need to be evaluated. Few businesses have escaped the repercussions of the pandemic. As a result, many entities will have some amount of doubt about events and conditions that could indicate a going concern problem. The critical question is whether the client has sufficient cash flow to survive in the COVID-19 environment and its aftermath. This concern is particularly difficult for clients that have not been able to operate at full capacity. For review engagements, the impact on the report needs to be considered as well as the adequacy of the going concern disclosures.

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

Change in Accounting Principle. A change in accounting principle does not require modifying the accountant's compilation or review report or adding an emphasis-of-matter or other-matter paragraph. However, an accountant is not precluded from adding such a paragraph about the change as long as the change is properly accounted for and adequately disclosed in the financial statements. However, for the reasons discussed earlier in this section, the authors recommend that accountants avoid using emphasis-of-matter and other-matter paragraphs whenever possible. SSARS do not prescribe a placement for the additional paragraph. In a review report, the accountant should include the paragraph within a separate section with an appropriate heading.

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

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

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

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

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

FASB ASC 250-10 provides guidance on measurement and disclosure of an accounting change, which FASB ASC 250-10-20 refers to as a *change in an accounting principle*, a change in an accounting estimate, or a change in the reporting entity. FASB ASC 250-10-20 indicates that a *change in an accounting principle* results when an entity changes from one generally accepted accounting principle to a different generally accepted accounting principle

when two or more generally accepted accounting principles could apply or when the accounting principle previously used is no longer generally accepted.

The guidance in FASB ASC 250-10 was therefore designed to address a change within one financial reporting framework—accounting principles generally accepted in the United States of America. It was not designed to address a change from one financial reporting framework to another financial reporting framework. For example, it was not designed to address a change from the income tax basis of accounting to accounting principles generally accepted in the United States of America or vice versa. As a practical matter, accounting literature does not address financial reporting frameworks other than accounting principles generally accepted in the United States of America.

Nevertheless, AICPA Technical Q&A 9030.10 states that when a change in accounting basis occurs, it should be disclosed in the notes to the financial statements. The authors' opinion differs from that expressed in the Q&A, because FASB ASC 250-10 does not apply to a change in a special purpose framework (which the Q&A acknowledges). Accordingly, such guidance does not have to be considered in special purpose financial statements. However, depending on the facts and circumstances, disclosure of the change in accounting basis may be helpful to users of the financial statements.

Finally, while not required, accountants may add an emphasis-of-matter paragraph to their compilation or review report to highlight a change in the financial reporting framework. If accountants decide to add an emphasis-of-matter paragraph to their report, and the financial statements appropriately disclose the change in basis, an explanatory paragraph such as the following may be added to the compilation report:

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

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

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

Use of Different Bases of Accounting for Financial Statements of the Same Period. Companies may request that accountants compile or review financial statements for the same period based on different bases of accounting. For example, a regulatory agency might require that a company use the accounting basis it uses for preparing its federal income tax returns to prepare financial statements it submits to the agency, while a bank may request GAAP financial statements for the same period of time. Accountants sometimes question whether they should or may add an emphasis-of-matter paragraph to their report on the special purpose financial statements to highlight that both GAAP and special purpose financial statements exist for the same period of time. However, the SSARS do not address this issue. Consequently, the authors believe that accountants are permitted (but not required) to add such a paragraph to their compilation or review reports.

Restricting the Use of Reports

AR-C 90A.103–.104 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 90A.103–.104 indicate that the use of an accountant's review report should be restricted when the subject matter of the report or presentation being reported on is based on measurement or disclosure

criteria suitable only for a specific audience. AR-C 90A.81 indicates that an other-matter paragraph, under an appropriate heading, that restricts the use of the report should be included in an accountant's review report on contractual basis financial statements following the guidance in AR-C 90A.104.

The compilation guidance in AR-C 80A does not address restricted use reports. However, the AICPA Guide, Paragraph 2.86, notes that an accountant may use a restricted use paragraph in a compilation report.

Some CPAs have asked, however, if it is permissible to restrict the use of compilation and review reports that are not otherwise required by professional standards to be restricted. The answer is yes, such restriction is permissible. Although there are circumstances when the report is required to carry a use restriction, the accountant is not prohibited from restricting the use of any report. 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 acknowledgment, preferably in writing, from the other parties of their understanding of the nature of the engagement, the measurement or disclosure criteria used in the engagement, and the related report. If the other parties are added after the accountant has issued his or her report, the report may be reissued with the additional specified parties listed or the accountant may provide a written acknowledgment to management and the additional parties acknowledging that the additional parties have been added as specified parties. If the report is reissued, the report date should not be changed. If the acknowledgment is made to management, it should state that no procedures have been performed subsequent to the date of the report (AR-C 90A.105–.106).

According to AR-C 90A.104, the restricted-use accountant's report should (a) indicate that the report is intended solely for the information and use of the specified parties, (b) identify the specified parties, either in the report or by referring to the specified parties listed elsewhere in the report, and (c) state that the report is not intended to be and should not be used by anyone other than the specified parties. A paragraph such as the following may be used as the last paragraph in the restricted use accountant's review report:

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

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

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

Client-prepared Financial Statements

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

According to Paragraph 2.59 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 or her report on compiled or reviewed financial statements, in reality, he or she has little control over or awareness of the client's subsequent actions. However, situations will occur when the accountant becomes aware that the financial statements will be combined with client-prepared financial statements into a new document. (The authors do not consider a file folder that contains loose copies of client-prepared financial statements and the separately bound compiled or reviewed financial statement in the accountant's report jacket to be a new document.) When the accountant becomes aware that such a "new document" will be created by the client, 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/audited financial statement, the accountant should advise the client to (a) remove all mention of the accountant's name from the document, (b) move the client-prepared statement to a separate page and add a disclaimer, or (c) have the accountant also prepare, compile, review, or audit the client-prepared statement.

The Client's Disclaimer. As noted in the previous paragraph, 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, reviewed, or audited financial statements and (b) contain a disclaimer. In the authors' opinion, the client's disclaimer would be presented on a page immediately preceding the client-prepared financial statements or on the face of such statements. Although not mandatory, an officer of the company could sign the disclaimer. Such a disclaimer might read as follows:

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

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

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

Reporting on Compiled or Reviewed Supplementary Information

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

> The accompanying 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 accompanying 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. If a separate report is issued, the accountant may consider adding a first sentence that refers to the accountant's compilation report on the basic financial statements.

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

When reviewed financial statements are accompanied by supplementary information, (whether prepared by the accountant or by the client), AR-C 90A.126–.128 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.

e. The accountant has not audited the supplementary information and, accordingly, does not express an opinion on such information.

AR-C 90A.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.

AR-C 90A.91 does not prescribe a placement for the other-matter paragraph.

SELF-STUDY QUIZ

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

1. Which of the following is a required element of a compilation report?
   a. A statement that the accountant is responsible for the financial statements.
   b. A statement that the compilation was performed in accordance with SSARS.
   c. The date of the engagement letter.
   d. The beginning and ending date of the auditor's compilation procedures.
2. After the implementation of SSARS No. 25, AR-C 90A.76 requires a report on reviewed financial statements to include all of the following **except:**
   a. A title that specifically indicates that it is the accountant's review report and includes the word independent.
   b. The accountant's or the firm's signature.
   c. The date of the review report.
   d. A description of any other procedures the accountant performed before or during the review engagement.
3. When should a review report contain an other-matter paragraph restricting the use of the accountant's report?
   a. When the financial statements are prepared under the contractual basis of accounting.
   b. When the accountant for the current period is not the continuing accountant.
   c. When the financial statements are revised for a subsequently discovered fact.
   d. When substantial doubt exists about the entity continuing as a going concern.
4. Which of the following statements concerning a change in accounting principle is correct?
   a. A change in tax law is considered to be a change in accounting principle in tax basis financial statements.
   b. Accountants are not required to add an emphasis-of-matter paragraph to their compilation or review report if an accounting principle changes.
   c. If a change in accounting principle is not properly accounted for, the accountant should withdraw from the engagement.
   d. If the change is disclosed in the financial statements, the accountant is prohibited from adding an emphasis-of-matter or other-matter paragraph.

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 is a required element of a compilation report? **(Page 108)**

   a. A statement that the accountant is responsible for the financial statements. [This answer is incorrect. AR-C 80A.17 requires a written report on compiled financial statements to include a statement that management, not the accountant, is responsible for the financial statements.]

   b. **A statement that the compilation was performed in accordance with SSARS. [This answer is correct. One of the elements required by AR-C 80A.17 for compilation reports is a statement that the accountant performed the compilation engagement in accordance with SSARS issued by the Accounting and Review Services Committee of the AICPA.]**

   c. The date of the engagement letter. [This answer is incorrect. Including the date of the compilation report (not the engagement letter) is a required element of the written report on compiled financial statements. The date of the engagement letter is not included.]

   d. The beginning and ending date of the auditor's compilation procedures. [This answer is incorrect. AR-C 80A.17 does not require the date the auditor began or ended the compilation procedures. However, the accountant is required to specify the date or period covered by each financial statement.]

2. After the implementation of SSARS No. 25, AR-C 90A.76 requires a report on reviewed financial statements to include all of the following **except: (Page 109)**

   a. A title that specifically indicates that it is the accountant's review report and includes the word independent. [This answer is incorrect. AR-C 90A.76 requires a report on reviewed financial statements to have a title that clearly indicates that it is the accountant's review report and includes the word *independent*.]

   b. The accountant's or the firm's signature. [This answer is incorrect. AR-C 90A.76 requires a report on reviewed financial statements to include the signature of the accounting firm or the accountant.]

   c. The date of the review report. [This answer is incorrect. AR-C 90A.76 requires the date of the review report. The date of the accountant's report should be the date that the accountant obtains sufficient appropriate review evidence to base his or her conclusion on the financial statements.]

   d. **A description of any other procedures the accountant performed before or during the review engagement. [This answer is correct. 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.]**

3. When should a review report contain an other-matter paragraph restricting the use of the accountant's report? **(Page 116)**

   a. **When the financial statements are prepared under the contractual basis of accounting. [This answer is correct. When financial statements are prepared in accordance with a special purpose framework, the review report should include an other-matter paragraph that restricts use of the accountant's review report when the financial statements are prepared in accordance with the contractual basis of accounting.]**

   b. When the accountant for the current period is not the continuing accountant. [This answer is incorrect. If the prior period was reported on by a predecessor and the financial statements of the prior period have been restated, the successor accountant can, among other things, report on the financial statements for both periods. However, this situation would not call for the use to be restricted.]

c. When the financial statements are revised for a subsequently discovered fact. [This answer is incorrect. When management revises financial statements for a subsequently discovered fact that became known after the report release date and the review report on the revised statements differs from the review report on the original statements, the accountant's review report should include an emphasis-of-matter (not an other-matter) paragraph. Additionally, no report restriction would need to be considered.]

d. When substantial doubt exists about the entity continuing as a going concern. [This answer is incorrect. 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, AR-C 90A.109 requires a *separate section* in the accountant's review report, not an other-matter paragraph. Also, the report would not be restricted.]

4. Which of the following statements concerning a change in accounting principle is correct? **(Page 120)**

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

b. **Accountants are not required to add an emphasis-of-matter paragraph to their compilation or review report if an accounting principle changes. [This answer is correct. A change in accounting principle does not require modifying the accountant's compilation or review report or adding an emphasis-of-matter or other-matter paragraph.]**

c. If a change in accounting principle is not properly accounted for, the accountant should withdraw from the engagement. [This answer is incorrect. If the change in accounting principle is not properly accounted for, management does not have reasonable justification for the change, or appropriate disclosures are not included in the financial statements, accountants would modify their compilation or review reports (not withdraw from the engagement) because of a departure from the applicable financial reporting framework.]

d. If the change is disclosed in the financial statements, the accountant is prohibited from adding an emphasis-of-matter or other-matter paragraph. [This answer is incorrect. An accountant is not precluded (or prohibited) from adding such a paragraph about the change as long as the change is property accounted for and adequately disclosed in the financial statements.]

THE AUDITOR'S REPORTS

The Auditor's Unmodified Report

The reporting standards for auditor's reports on special purpose financial statements are prescribed by AU-C 800. The guidance also provides illustrations of reports. The reporting standards are similar to those for reporting on GAAP basis financial statements prescribed by AU-C 700.

The auditor's report is required to be in writing. The principal elements of an auditor's unmodified report in accordance with AU-C 700.21–.37, which also generally apply to a report on special purpose financial statements, are as follows:

- A title that clearly indicates the report is that of an independent auditor.
- An addressee appropriate for the circumstances of the engagement.
- An "Opinion" section, which is required to be the first section of the auditor's report, that has the heading "Opinion" and includes the auditor's opinion on the financial statements. The Opinion section of the report also includes the name of the entity, the titles of the financial statements, a statement that the financial statements were audited, the identification of the financial reporting framework, and the date or period covered by the financial statements It also includes a reference to the notes to the financial statements. The wording of the auditor's opinion on the financial statements is unchanged.
- A "Basis for Opinion" section, directly following the Opinion section, that (1) states that the audit was conducted in accordance with U.S. GAAS, (2) refers to the section of the report that describes the auditor's responsibilities, (3) states that the auditor is required to be independent and to meet other ethical responsibilities, and (4) states that the auditor believes that the audit evidence is sufficient and appropriate to provide a basis for the opinion.
- A description of management's responsibilities for the financial statements in a section with the heading "Responsibilities of Management for the Financial Statements." This section states management's responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and for the maintenance of internal control relevant to the preparation and presentation of the financial statements, and also is required to include a statement regarding management's responsibility to evaluate whether there are conditions or events that raise substantial doubt about the entity's ability to continue as a going concern (when management has such a responsibility under the applicable financial reporting framework).
- A description of the auditor's responsibilities for the audit in a section with the heading "Auditor's Responsibilities for the Audit of the Financial Statements." In addition to the description of the auditor's responsibilities, this section also is required to state that (1) the auditor's objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error and to issue a report that includes the auditor's opinion; (2) reasonable assurance is a high level, but not absolute, assurance and is not a guarantee that an audit will detect a material misstatement when it exists; (3) misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements; (4) the auditor exercises professional judgment and maintains professional skepticism throughout the audit; (5) the risk of not detecting a material misstatement resulting from fraud is higher than one resulting from error; (6) the auditor's responsibilities include concluding on the entity's ability to continue as a going concern; and (7) the auditor communicates with those charged with governance about, among other matters, the planned scope and timing of the audit and significant audit findings, including certain significant internal control-related matters that the auditor identifies.
- Signature of the auditor's firm, either manual or printed.
- City and state where the auditor's report is issued.
- Date of the auditor's report.

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

a. In the section titled "Management's Responsibility for the Financial Statements," a reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances, when management has a choice of financial reporting frameworks in the preparation of such financial statements. (AU-C 800.19b)

b. An emphasis-of-matter paragraph, under an appropriate heading, that indicates that the financial statements are prepared in accordance with the applicable special purpose framework, refers to the note to the financial statements that describes that framework, and states that the special purpose framework is a basis of accounting other than GAAP (AU-C 800.20a–c). When the financial statements are prepared in accordance with a regulatory or contractual basis of accounting, or an other basis of accounting and the auditor is required to restrict use of the report pursuant to AU-C 905.06a–b, the paragraph also should include a description of the purpose for which the financial statements are prepared and a statement that the financial statements may not be suitable for another purpose, or a reference to a note that contains that information. (AU-C 800.19a and AU-C 800.20d)

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

c. An other-matter paragraph, under an appropriate heading, that restricts the use of the auditor's report when the special purpose financial statements are prepared in accordance with a contractual basis of accounting, a regulatory basis of accounting, or an other basis of accounting when required under AU-C 905.06a–b (AU-C 800.21). A discussion later in this lesson provides guidance if regulatory basis financial statements will not be restricted in their use.

In addition, when applicable, the auditor's report is required to include—

- A separate section when the auditor concludes there is substantial doubt about the entity's ability to continue as a going concern.

- A separate section that includes the auditor's report on information included in an entity's annual report as required by AU-C 720, *The Auditor's Responsibility Relating to Other Information Included in Annual Reports*.

Furthermore, the auditor may include a section in the auditor's report communicating key audit matters when engaged to do so. When the auditor communicates key audit matters in the auditor's report, the auditor is required to do so in accordance with AU-C 701. AU-C 701 describes key audit matters as matters that (a) the auditor concludes were of most significance in the audit of the financial statements and (b) are selected from matters communicated to those charged with governance. The authors believe that it would be unusual for an auditor to be engaged to communicate key audit matters in the audit of special purpose financial statements. Accordingly, key audit matters are not further discussed in this course. *PPC's Guide to Auditor's Reports* discusses key audit matters in detail.

Modifications to the Auditor's Report

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

a. *Qualified Opinion.* The auditor should express a qualified opinion when (AU-C 705.08)—

   •• the auditor concludes that misstatements, individually or in the aggregate, are material but not pervasive to the financial statements, or

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

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

b. *Adverse Opinion.* Auditors give an adverse opinion when they conclude that misstatements, individually or in the aggregate, from the special purpose framework are both material and pervasive to the financial statements (AU-C 705.09). Adverse opinions are rare in practice because their implications are so serious that they usually cause the company to correct the financial statements.

c. *Disclaimer of Opinion.* A disclaimer of opinion states that the auditors are unable to obtain sufficient appropriate audit evidence on which to base the opinion on the financial statements and the auditors conclude that the possible effects of undetected misstatements, if any, could be both material and pervasive (AU-C 705.10). Generally, auditors issue a disclaimer of opinion when they are faced with a scope limitation so significant that they believe a qualified opinion is not appropriate.

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

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

- **Required Elements of an Emphasis-of-matter Paragraph.** AU-C 706.09 requires an emphasis-of-matter paragraph to be included in a separate section of the auditor's report and to (a) use an appropriate heading, and when key audit matters are also communicated in the auditor's report, include the term "Emphasis of Matter" in the headings, (b) include a reference to the matter being emphasized and to where in the financial statements disclosures relevant to the matter can be found, and (c) state that the emphasis paragraph does not modify the auditor's opinion on the financial statements. When practicable, the authors prefer to use a heading for the emphasis paragraph that is descriptive of the matter being emphasized. For example, an emphasis-of-matter paragraph describing a change in accounting principle might use a heading such as "Change in Accounting Principle." AU-C 706 does not specify a location for the emphasis-of-matter section within the auditor's report. Thus auditors have flexibility to locate it within the auditor's report depending on the significance of the information being communicated in relation to the other elements of the auditor's report. Report illustrations in Exhibit A of AU-C 706 show the emphasis-of-matter section immediately following the Basis for Opinion section.

- **Required Elements of an Other-matter Paragraph.** AU-C 706.10–.11 requires an other-matter paragraph to be presented in a separate section of the auditor's report with the heading "Other Matter" or other appropriate heading (and the subject of the other-matter section should not be a key audit matter when the auditor's report communicates key audit matters). When practicable, the authors prefer to use a heading that is descriptive of the matter being emphasized. For example, an other-matter paragraph restricting the use of the auditor's report when the financial statements are prepared on the regulatory basis of accounting might use a heading such as "Restriction on Use. Because an other-matter paragraph refers to matters other than those that are appropriately presented or disclosed in the financial statements, it would be inappropriate for the content of an other-matter paragraph to imply that the matter is required to be presented and disclosed in the financial statements. An other-matter paragraph also does not include (a) information that the auditor is prohibited from providing by law, regulation, or other professional standards (for example, ethical standards relating to the confidentiality of information) or (b) information that is required to be provided by management.

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

Exhibit 1-1

Modifying the Auditor's Report

Type of Report	Circumstance	Materiality[a]	How to Modify the Auditor's Report
QUALIFIED OPINION	Departure from GAAP (measurement or disclosure)	Material	Qualify the opinion (except for) and include a basis for qualified opinion section following the opinion section.
	Scope limitation	Material	Qualify the opinion (except for) and include a basis for qualified opinion section following the opinion section.
ADVERSE OPINION	Pervasive departure from special purpose framework	Material	Modify the opinion to state "do not present fairly in accordance with (the special purpose framework)" and include a basis for adverse opinion section following the opinion section.
DISCLAIMER OF OPINION	Pervasive scope limitation	Material	Modify the opinion to state "we do not express an opinion," include a basis for disclaimer of opinion section following the opinion section, and modify the description of the auditor's responsibility for the audit of the financial statements.
	Not independent and a nonpublic company[b]	n/a	Issue a SSARS compilation report that states the lack of independence.[c, d]
	Unaudited financial statements of a nonpublic company[b]	n/a	Issue a SSARS compilation or review report.[c]
UNMODIFIED OPINION WITH EMPHASIS-OF-MATTER or OTHER-MATTER PARAGRAPH	Auditors decide or are required to emphasize a matter appropriately presented or disclosed in the financial statements	n/a	Add an emphasis-of-matter paragraph discussing the matter in a separate section, generally following the basis for opinion section, but issue an unmodified opinion.[e]
	Auditors decide or are required to emphasize a matter other than those presented or disclosed in the financial statements	n/a	Add an other-matter paragraph discussing the matter in a separate section, generally following the basis for opinion section (and any emphasis-of-matter sections), but issue an unmodified opinion.[f]

Notes:

[a] If the circumstance is not material to the financial statements as a whole, auditors should not modify their report.

[b] The authors also refer to these types of reports as disclaimers of opinion even though the term *disclaimer* in AU-C 705 is used in a narrower sense.

[c] SSARS standards require accountants to issue a report when they are engaged to compile or review financial statements.

[d] SSARS standards allow an accountant to include a description in the compilation report regarding the reason for an independence impairment.

[e] AU-C 706 does not specify a location for the emphasis-of-matter section within the auditor's report. Thus, auditors have flexibility to locate the section within the auditor's report depending on the significance of the information being communicated in relation to the other elements of the auditor's report. Report illustrations in Exhibit A of AU-C 706 show the emphasis-of-matter section directly following the basis for opinion section.

[f] AU-C 706 does not specify a location for the other-matter section within the auditor's report, and the authors believe that location generally depends on the nature of the matter being communicated. Often the other-matter section follows the basis for opinion section of the report, for example, when communicating the auditor's updated opinion on the prior-period financial statements.

Departures from the Applicable Financial Reporting Framework. Financial statements may contain departures from the applicable financial reporting framework (for example, income tax basis financial statements that fail to include an income tax provision). When departures are material, AU-C 800.15 refers auditors to the guidance in AU-C 705 for opinion modifications.

Under AU-C 705, when the auditor modifies the audit opinion because the financial statements contain a material departure, in addition to including the specific elements required for the auditor's unmodified report as discussed earlier in this section, the auditor is required to—

- Use the heading "Qualified Opinion" or "Adverse Opinion," as appropriate, for the opinion section of the report to clearly indicate that the auditor's opinion is modified and the type of modification.
- Use the heading "Basis for Qualified Opinion" or "Basis for Adverse Opinion," as appropriate, for the basis for opinion section of the report when describing the matter giving rise to the modification.
- Amend the description (in the Basis for Qualified Opinion section of the report) of the sufficiency of audit evidence as a basis for the auditor's modified opinion to include the word "qualified" or "adverse," as appropriate; that is, the auditor's report would state that the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's qualified opinion or for the auditor's adverse opinion.

In addition, when the auditor's report includes an adverse opinion, the report should not include a section discussing Key Audit Matters (unless such reporting is required by law or regulation) because it may overshadow the fact that the financial statements as a whole are materially misstated.

Inadequate Disclosure. Inadequate disclosure is also considered a departure from the applicable financial reporting framework that could cause auditors to express a qualified or adverse opinion. If the financial statements or accompanying notes are misstated because of misstated, inappropriate, or inadequate disclosures, auditors should express a qualified (except for) or an adverse opinion. AU-C 705.23 requires material misstatements of the financial statements that relate to qualitative disclosures to be described in the Basis for Opinion section. In addition, if the financial statements omit information required to be presented or disclosed, AU-C 705.24 requires the auditor to—

- Discuss the omission with those charged with governance.
- Describe the nature of the omitted information in the basis for opinion section.
- Include the information, provided that it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

Practicable means that the information is reasonably obtainable from management's accounts and records and that auditors are not required to assume the position of preparers to provide the information in their report.

In practice, auditors rarely issue a qualified or adverse opinion due to inadequate disclosure since, at a minimum, the nature of the omitted disclosure must be described in the auditor's report even if the company objects to financial statement disclosure. However, there may be certain disclosure requirements that the company believes are not cost-beneficial to generate and, accordingly, auditors sometimes issue a qualified opinion in those circumstances.

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

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

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

Uncertainties about the Entity's Ability to Continue as a Going Concern. FASB ASC 205-40 provides guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related disclosures in the financial statements. Substantial doubt about an entity's ability to continue as a going concern exists when aggregate conditions and events indicate it is *probable* that the entity will not be able to meet its obligations as they are due during the year following the date the financial statements are available to be issued (or within one year after the date that the financial statements are available to be issued, when applicable). The guidance, in defining substantial doubt, uses the term *probable*, which means likely to occur. For each reporting period, FASB ASC 205-40-50-1 requires management to evaluate whether conditions or events indicate there is substantial doubt about the entity's ability to continue as a going concern for the year subsequent to the date the financial statements are issued or the date the financial statements are available to be issued. However, special purpose frameworks are not GAAP and such frameworks may not include an explicit requirement for management to evaluate the entity's ability to continue as a going concern for a reasonable period of time.

Reporting Responsibilities. In all engagements to report on special purpose financial statements, auditors should (a) conclude whether, in the auditor's judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and (b) when substantial doubt exists, to evaluate the adequacy of financial statement disclosures (AU-C 800.14). Thus, the auditor's going concern considerations as set forth in AU-C 800 are consistent with those in AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

Furthermore, AU-C 800.14 clarifies that regardless of whether the going concern basis of accounting is or is not relevant to the financial reporting framework and management's responsibilities to consider going concern, the auditor's responsibilities as stated in AU-C 800.14 should be addressed in all audits of special purpose financial statements. That determination is important because it affects (a) the auditor's responsibility to obtain sufficient appropriate audit evidence regarding, and to conclude on, the appropriateness of management's use of the going concern basis of accounting and (b) the wording in the auditor's report about management's going concern responsibilities. AU-C 800.A18 states that the going concern basis of accounting is relevant to a special purpose framework if the framework requires management to use a basis of accounting other than the going concern basis in certain circumstances (for example, similar to the way that GAAP requires management to prepare its financial statements on the liquidation basis of accounting rather than the going concern basis when certain conditions exist). AU-C 800.A18 also states that the going concern basis of accounting is not relevant to financial statements prepared on the cash or the income tax basis because those bases of accounting do not specify an alternative basis of accounting to be considered, so management has no requirement to assess whether the going concern basis of

accounting is appropriate. Accordingly, in engagements to report on financial statements prepared on the cash or income tax basis of accounting—

- Auditors are not required to evaluate whether management's use of the going concern basis is appropriate, and
- The description of management's responsibilities in the auditor's report would omit reference to a responsibility to evaluate whether conditions or events raise substantial doubt about the entity's ability to continue as a going concern.

The authors believe that a determination of whether the going concern basis of accounting is relevant to financial statements prepared on the regulatory or contractual basis of accounting (and the related effect on management's going concern responsibilities and the description of them in the auditor's report) depends on the specifics of the regulatory or contractual provisions that apply to the preparation of the financial statements.

When the auditor concludes there is substantial doubt about the entity's ability to continue as a going concern (after considering relevant conditions and events and management's plans), AU-C 570 requires that the auditor's conclusion about substantial doubt be expressed in a separate section in the auditor's report), and prescribe the form and content of the separate section. The separate going concern section should—

- Use the heading "Substantial Doubt About the Entity's Ability to Continue as a Going Concern."
- Highlight the notes to the financial statements, which disclose (a) the conditions and events identified and management's plans to deal with them and (b) that the conditions and events raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- State that the auditor's opinion is not modified with respect to the going concern matter.

Auditors should not use conditional language when expressing their conclusion about the substantial doubt.

The requirements that auditors should follow to achieve the reporting objectives set out in AU-C 570 include—

- When the financial statements have been prepared using the going concern basis of accounting but the auditor believes the basis is inappropriate, express an adverse opinion (AU-C 570.23).
- Include a separate section in the auditor's report with the heading "Substantial Doubt About the Entity's Ability to Continue as a Going Concern" when the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains after considering identified conditions or events and management's plans. The separate section should (a) refer to relevant financial statement disclosures about the uncertainty and (b) state that the auditor's opinion is not modified with respect to that matter (AU-C 570.24).
- In the going concern section of the auditor's report, use terms consistent with the applicable financial reporting framework about the entity's ability to continue as a going concern (AU-C 570.25). (Do not use conditional language concerning the existence of substantial doubt about the entity's ability to continue as a going concern.)
- If there is inadequate disclosure about the entity's ability to continue as a going concern, (a) express a qualified or adverse opinion, as appropriate, in accordance with AU-C 705 and (b) state in the basis for qualified or adverse opinion section that substantial doubt exists, and, if applicable, that the substantial doubt has been alleviated by management's plans, and that financial statement disclosure is inadequate (AU-C 570.26).
- If management is unwilling to perform or extend its evaluation to meet the required time period under the applicable financial reporting framework, consider the implications on the auditor's report (AU-C 570B.27).
- In comparative presentations, do not repeat the prior year going concern section if substantial doubt has been removed in the current period (AU-C 570.29).

- Reassess the entity's going concern status if requested to reissue a report and eliminate a going concern section in the auditor's report (AU-C 570.30).

Illustrated below is an example from AU-C 570.A65 of the separate section in the auditor's report if, after considering identified conditions or events and management's plans, the auditor concludes that substantial doubt remains about the entity's ability to continue as a going concern for a reasonable period of time.

> **Substantial Doubt about the Company's Ability to Continue as a Going Concern**
>
> 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 suffered recurring losses from operations, has a net capital deficiency, and 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 opinion is not modified with respect to that matter.

Although AU-C 570 does not prescribe a location for the going concern section in the auditor's report, the report illustrations in AU-C 570 show the going concern section immediately following the basis for opinion section of the report. However, auditors have flexibility in deciding where to place the going concern section within the auditor's report. *PPC's Guide to Auditor's Reports* provides further information about going concern reporting considerations and illustrative report language.

The amendments to AU-C 570 also require that if the auditor expresses a qualified or adverse opinion because of inadequate disclosure of going concern uncertainties, the Basis for Opinion section of the auditor's report is required to state either that (a) substantial doubt exists about the entity's ability to continue as a going concern or (b) substantial doubt about the entity's ability to continue as a going concern has been alleviated by management's plans, as appropriate, but that the financial statements fail to adequately disclose those matters.

COVID-19 Implication on Going Concern. The topic of going concern is especially relevant today, given the significant impact of COVID-19 on nonpublic businesses in 2021 and 2022, and likely beyond, and may result in numerous going concern issues in audit engagements. While some entities may not have been negatively impacted by the COVID-19 global pandemic, entities in many different industries and locations have experienced negative impacts that need to be evaluated. Few businesses have escaped the repercussions of the pandemic. As a result, many entities will have some amount of doubt about events and conditions that could indicate a going concern problem. The critical question is whether the client has sufficient cash flow to survive the COVID-19 environment and its aftermath. This concern is particularly difficult for clients that have not been able to operate at full capacity. For audit engagements, the impact on the report needs to be considered as well as the adequacy of the going concern disclosures.

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

Expressing an Opinion on Prior-year Financial Statements That Is Different from the Opinion Previously Expressed. If auditors express an opinion on prior-period financial statements that differs from their previous opinion, the updated report should disclose all of the substantive reasons for the change in the opinion. AU-C 706 does not specify a location for the other-matter section within the auditor's report. Thus, auditors have flexibility to locate the section within the auditor's report depending on the significance of the information being communicated in relation to the other elements within the auditor's report. Illustration 3 in Exhibit A of AU-C 706 shows the other matter section when the auditor issues an updated report on the financial statements of a prior periods directly following the basis for opinion section. The paragraph should disclose—

a. the date of the auditor's previous report,

b. the type of opinion previously expressed,

c. the substantive reasons that caused the auditors to express a different opinion, and

d. the fact that the auditor's updated opinion on the prior-period financial statements is different from the previous opinion on those statements.

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

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

a. the component auditor meets independence requirements and there are no serious concerns about competence;

b. the component's financial statements are prepared using the same financial reporting framework as the group financial statements or, if the financial reporting framework used by the component is different from that used by the group—

   (1) the measurement, recognition, presentation, and disclosure criteria applicable to all material items in the component's financial statements are similar to those used in the group's financial statements, and

   (2) the group auditor obtains sufficient audit evidence to evaluate the appropriateness of the adjustments needed to convert the component's statements to the framework used by the group without assuming responsibility for the component auditor's work;

c. the component auditor has performed an audit of the financial statements of the component in accordance with GAAS or, when required by law or regulation, with auditing standards promulgated by the Public Company Accounting Oversight Board (PCAOB); and

d. the component auditor has issued an auditor's report that is not restricted as to use.

AICPA Technical Q&A 8800.02 indicates that when there is more than one component auditor, the group auditor's decision to make reference is made individually for each component auditor. The group auditor may make reference to any, all, or none of the component auditors. When the group auditor decides to make reference to the work of a component auditor, AU-C 600.27 requires the group auditor to perform certain procedures to obtain audit evidence about the component, including reading the component's financial statements, the component auditor's report, and communicating with the component auditor.

The illustrative auditor's reports on group financial statements in Exhibit A of AU-C 600 show reference to the component auditor in separate paragraphs directly following the auditor's opinion in the opinion section of the report. An example of those paragraphs with language italicized follows:

> **Opinion**
>
> We have audited the accompanying consolidated financial statements of ABC Company and its subsidiaries, which comprise the consolidated statements of assets, liabilities, and stockholders' equity—income tax basis as of December 31, 20X1 and 20X0, and the related consolidated statements of revenues, expenses, and changes in stockholders' equity—income tax basis for the years then ended, and the related notes to the financial statements.
>
> In our opinion, *based on our audit and the report of the other auditors*, the consolidated financial statements referred to above present fairly, in all material respects, the assets, liabilities, and

stockholders' equity—income tax basis of ABC Company and its subsidiaries as of December 31, 20X1 and 20X0, and the results of their revenues, expenses, and changes in stockholders' equity for the years then ended, in accordance with the basis of accounting ABC Company and its subsidiaries use for income tax purposes as described in Note A.

We did not audit the income tax basis financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets constituting 20% and 22%, respectively, of consolidated total assets at December 31, 20X1 and 20X0, and total revenues constituting 18% and 20%, respectively, of consolidated total revenues for the years then ended. Those income tax basis statements were audited by other auditors, whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

Change in Basis of Accounting. Companies sometimes change the basis of accounting used to present their financial statements from a special purpose framework to GAAP, from GAAP to a special purpose framework, or from one special purpose framework to another. However, AICPA Technical Q&A 9030.10 indicates that a change in basis of accounting is not a change in accounting principle as defined in FASB ASC 250-10-20. Nevertheless, AU-C 706 allows auditors to include an emphasis-of-matter paragraph in the auditor's report to draw users' attention to a matter that is appropriately presented or disclosed in the financial statements when, in the auditor's professional judgment, it is of such importance that it is fundamental to users' understanding of the financial statements. In such circumstances, the emphasis-of-matter paragraph would state that the entity has changed the basis of accounting used to prepare the financial statements from one financial reporting framework to another. The authors also believe that the paragraph may disclose that another report has been issued on the company's financial statements prepared in conformity with another financial reporting framework (such as when GAAP financial statements are issued in addition to cash basis financial statements). The following illustrates an emphasis-of-matter paragraph that may be added to the audit report to emphasize a change in the basis of accounting:

Basis of Accounting

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

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

Reporting on Supplementary Information

The following standards contain the authoritative literature for reporting on supplementary information:

- AU-C 720, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*.
- AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*.

The following paragraphs summarize important provisions from that guidance.

Other Information Included in Annual Reports. AU-C 720 applies to financial and nonfinancial information, other than the financial statements and the auditor's report, included in the entity's annual report. Examples of other information include management reports, financial summaries, employment information, financial ratios, etc. An annual report can be a single document or a set of documents prepared to provide the reader with information about the entity's operations and financial results. It includes or incorporates by reference the entity's financial statements

and auditor's report. The application guidance in AU-C 720 makes clear that neither IRS Form 990, *Return of Organization Exempt from Income Tax*, nor IRS Form 550, *Annual Return/Report on Employee Benefit Plan*, is considered an annual report. AU-C 720 requires auditors to read other information in an entity's annual report, consider whether the information is materially inconsistent with the financial statements or is materially misstated or otherwise misleading, and issue an appropriate report. Entities reporting under a special purpose framework do not normally publish annual reports and, thus, further information is not provided in this course. See *PPC's Guide to Auditor's Reports* for information on those requirements.

Supplementary Information in Relation to the Financial Statements as a Whole. When the auditor is engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, AU-C 725 includes procedures the auditor must apply when determining whether the supplementary information is fairly stated in relation to the basic financial statements as a whole. An auditor's report on supplementary information may be either presented separately or included as a separate section of the auditor's report on the financial statements.

SELF-STUDY QUIZ

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

5. Ally is hired to audit a company's income tax basis financial statements. She is satisfied with the financial statements as a whole, except for an immaterial inconsistency in how the company applied a certain accounting principle. How should Ally modify the auditor's report for this concern?

   a. Add an emphasis-of-matter paragraph.

   b. Issue a disclaimer of opinion.

   c. Issue an adverse opinion.

   d. Issue a qualified opinion.

6. Which of the following statements regarding departures from the applicable financial reporting framework is correct?

   a. Inadequate disclosure is considered a departure that could result in a qualified or adverse opinion.

   b. Omitting an income tax provision from income tax basis financial statements is not considered a departure.

   c. If the auditor's report includes an adverse opinion, the report is required to include a section discussing Key Audit Matters.

   d. If modifying the audit opinion due to the financial statements including a material departure, headings for the opinion section may be omitted.

7. According to AU-C 706, when auditors include an other-matter section to express an opinion on prior-period financial statements that differs from their previous opinion, where should the section be placed?

   a. The section must be placed on the first page of the auditor's report.

   b. The section must be a separate document from the auditor's report, not included in it.

   c. The auditor must follow specific guidance in AU-C 706 for the placement of the section.

   d. The auditor can place it depending on its significance in relation to other elements in the auditor's 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.)**

5. Ally is hired to audit a company's income tax basis financial statements. She is satisfied with the financial statements as a whole, except for an immaterial inconsistency in how the company applied a certain accounting principle. How should Ally modify the auditor's report for this concern? **(Page 132)**

   a. **Add an emphasis-of-matter paragraph. [This answer is correct. For the inconsistency described in this scenario, Ally could issue an unmodified opinion if she adds an emphasis-of-matter or other-matter paragraph discussing the matter in a separate section, generally following the basis for opinion section.]**

   b. Issue a disclaimer of opinion. [This answer is incorrect. Auditors generally issue a disclaimer of opinion when they are faced with a scope limitation so significant that they believe a qualified opinion is not appropriate.]

   c. Issue an adverse opinion. [This answer is incorrect. This opinion would only be given when an auditor concludes that misstatements, individually or in the aggregate, from the special purpose framework are both material and pervasive to the financial statements.]

   d. Issue a qualified opinion. [This answer is incorrect. Qualified opinions are issued when the auditor concludes that misstatements, individually or in the aggregate, are material but not pervasive to the financial statements, or the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.]

6. Which of the following statements regarding departures from the applicable financial reporting framework is correct? **(Page 134)**

   a. **Inadequate disclosure is considered a departure that could result in a qualified or adverse opinion. [This answer is correct. Inadequate disclosure is also considered a departure from the applicable financial reporting framework that could cause auditors to express a qualified or adverse opinion. If the financial statements or accompanying notes are misstated because of misstated, inappropriate, or inadequate disclosures, auditors should express a qualified (except for) or an adverse opinion.]**

   b. Omitting an income tax provision from income tax basis financial statements is not considered a departure. [This answer is incorrect. Financial statements may contain departures from the applicable financial reporting framework (for example, income tax basis financial statements that fail to include an income tax provision). This omission *is* considered a departure.]

   c. If the auditor's report includes an adverse opinion, the report is required to include a section discussing Key Audit Matters. [This answer is incorrect. When the auditor's report includes an adverse opinion, the report should *not* include a section discussing Key Audit Matters (unless such reporting is required by law or regulation) because it may overshadow the fact that the financial statements as a whole are materially misstated.]

   d. If modifying the audit opinion due to the financial statements including a material departure, headings for the opinion section may be omitted. [This answer is incorrect. Under AU-C 705, when the auditor modifies the audit opinion because the financial statements contain a material departure, in addition to including other required elements for the auditor's unmodified report, the auditor is required to use the heading "Qualified Opinion" or "Adverse Opinion," as appropriate, for the opinion section of the report to clearly indicate that the auditor's opinion is modified and the type of modification.]

7. According to AU-C 706, when auditors include an other-matter section to express an opinion on prior-period financial statements that differs from their previous opinion, where should the section be placed? **(Page 137)**

   a. The section must be placed on the first page of the auditor's report. [This answer is incorrect. AU-C 706 does *not* specify that the other-matter section must be placed on the first page. Therefore, a different answer to this question is required.]

   b. The section must be a separate document from the auditor's report, not included in it. [This answer is incorrect. If auditors express an opinion on prior-period financial statements that differs from their previous opinion, the updated report (not a separate document) should disclose all of the substantive reasons for the change in the opinion.]

   c. The auditor must follow specific guidance in AU-C 706 for the placement of the section. [This answer is incorrect. AU-C 706 does not specify a location for the other-matter section within the auditor's report. Thus, a different answer is needed.]

   d. **The auditor can place it depending on its significance in relation to other elements in the auditor's report. [This answer is correct. Since AU-C 706 does not specify a location for the other-matter section within the auditor's report, auditors have flexibility to locate the section within the auditor's report depending on the significance of the information being communicated in relation to the other elements within the report.]**

DEALING WITH OTHER REPORTING SITUATIONS

Reporting on Regulatory Basis Financial Statements

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

Intended Solely for Regulatory Filing. As previously noted, if regulatory basis financial statements are intended to be used solely by parties within the entity and by one or more regulatory agencies, the auditor can report on them as special purpose framework financial statements. However, AU-C 800.21 indicates that a paragraph restricting use of the report to those within the company and one or more regulatory agencies should be added. These reports are appropriate only if a regulatory agency has developed detailed accounting requirements that are not in conformity with GAAP, and requires financial statements prepared in accordance with that regulatory basis of accounting.

It may be beneficial for the practitioner to review an illustrative example of an auditor's report on financial statements prepared using a regulatory basis of accounting that are not intended for general use, such as the report provided in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*. The illustrative report in that *Guide* includes the first paragraph in the opinion section that identifies the financial statements audited and states that the audit was made in accordance with auditing standards generally accepted in the United States of America. The second paragraph in the opinion section expresses the auditor's opinion about whether the financial statements are presented in conformity with the regulatory basis of accounting. The "Opinion" section of the report is followed by the "Basis for Opinion" section. (If the auditors conclude that the financial statements are not presented fairly on the regulatory basis, they should disclose their reasons for that conclusion under an appropriate heading such as "Basis for Qualified Opinion." The heading for the opinion section would also be modified to something such as "Qualified Opinion" and the opinion paragraph would be modified to refer to the basis for qualified opinion paragraph.) An emphasis-of-matter paragraph, under an appropriate heading (for example, "Basis of Accounting") follows the basis for opinion section, stating the basis of presentation and indicating that it is a basis of accounting other than GAAP and refers to the note to the financial statements that describes the basis. That paragraph also should describe the purpose for which the financial statements are prepared or refer to a note to the financial statements that contains that information. In addition, the report includes an other-matter paragraph, under an appropriate heading, restricting the report's use (which is appropriate even though the auditor's report may, by law or regulation, become a matter of public record).

Not Limited to Use in Regulatory Filings. AU-C 800.22 provides guidance on the form of reporting for financial statements prepared on a basis of accounting prescribed by a regulatory agency when the financial statements will not be limited to use in regulatory filings (in other words, intended for general use). In that situation, an other-matter paragraph restricting the use of the report would not be included. Instead, when the regulatory basis contains departures from GAAP, the auditor's report would be modified (i.e., a qualified or adverse opinion) because of the prescribed GAAP departures. The report also should include an additional paragraph that expresses an opinion on whether the financial statements are in conformity with the prescribed basis of accounting. This type of reporting is used when:

a. the financial statements and report are intended for use by parties other than those within the entity and one or more regulatory agencies to whose jurisdiction the entity is subject, or

b. the financial statements and report are distributed (either voluntarily or upon specific request) by the entity to parties other than the regulatory agencies to whose jurisdiction the entity is subject.

PPC's Guide to Cash, Tax, and Other Bases of Accounting also presents an example of an auditor's report appropriate for reporting on financial statements prepared on a regulatory basis of accounting that are intended for general use. The illustrative report presents an example of the type of report that should be used in the circumstances described in the previous paragraph. The report expresses two opinions: an unmodified opinion on the regulatory basis of accounting and an adverse opinion on the presentation of the financial statements in conformity with GAAP. When an adverse opinion is issued, AU-C 705.22 states that auditors should disclose the financial effect of the matter on the company's financial position, results of operations, and cash flows in the basis for opinion section of their report, if reasonably determinable, immediately following the opinion section. If it is not practicable to quantify the effects of the departure, the basis for opinion section should indicate that fact and state that the differences are presumed to be material. The basis for opinion section should include a description of the matter that gave rise to the adverse opinion (AU-C 705.21b). The report does not include an other-matter paragraph restricting the use of the report.

Considerations for Compilations and Reviews. The SSARS do not require the accountant's compilation or review report on special purpose financial statements prepared in accordance with the regulatory basis of accounting to describe the reason the financial statements were prepared. In addition, under the SSARS, the use of the accountant's report is not required to be restricted in review reports when the special purpose financial statements are prepared in accordance with the regulatory basis of accounting. (However, there is nothing in the SSARS to preclude the accountant from restricting the report if so desired.)

IRS Form 990

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

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

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

Financial Statements Intended for Distribution to Others. If Form 990 will be used for purposes other than regulatory filings (for example, copies of Form 990 are distributed to contributors or others), the regulatory basis report form discussed in the previous paragraph is not appropriate. In those cases, auditors should express a qualified or adverse opinion on the financial statements because of the departures from GAAP and, if reasonably determinable, disclose the effects of the GAAP departures on the financial statements. Otherwise, the report should state the effects are not reasonably determinable. AU-C 800.22 states auditors should add a paragraph expressing an opinion on conformity with the prescribed basis of accounting.

Considerations for Compilations and Reviews. Financial presentations included in tax returns would not be considered financial statements according to the definition of *financial statements* in the SSARS (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. AR-C 90A.A1–.A2 also state that the accountant may be engaged to review financial information included in a tax return.

Contractual Basis of Accounting

The auditing literature and the SSARS both describe the *contractual basis of accounting* as an accounting basis that is used by an entity to comply with the provisions of an agreement between the entity and other third parties (other than the auditor or accountant).

Audits. AU-C 800 includes specific additional requirements when reporting on contractual basis financial statements.

- AU-C 800.17 states that the auditor should evaluate whether contractual basis financial statements adequately describe any significant interpretations of the underlying contract upon which the financial statements are based.
- AU-C 800.19b states that the auditor's report should make reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances whenever management has a choice of financial reporting frameworks. The authors believe that it would be assumed that management did not have a choice of financial reporting frameworks if the financial statements are prepared on the contractual basis of accounting.
- AU-C 800.19a states that the auditor's report should describe the purpose for which the contractual basis financial statements were prepared or refer to a financial statement note with that information.
- AU-C 800.21 states that contractual basis financial statements should include an other-matter paragraph that restricts the use of the auditor's report to the entity and parties to the underlying contract.
- AU-C 800.20a–c states that financial statements prepared in accordance with a special purpose framework should include an emphasis-of-matter paragraph that alerts users of certain facts about the framework, including a description of the purpose for which the financial statements were prepared. When the framework is a contractual basis of accounting, the information in the emphasis-of-matter paragraph should also include a statement that the financial statements may not be suitable for another purpose (AU-C 800.20d).

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

Reviews. A review of contractual basis financial statements should be performed in accordance with AR-C 90A. The accountant should generally apply the same procedures as for a review of GAAP financial statements. Additional reporting requirements specific to reviewed special purpose financial statements, including contractual basis, are located in AR-C 90A.77–.81.

Compilations. A compilation of contractual basis financial statements should be performed in accordance with AR-C 80A. The accountant should generally apply the same procedures as for a compilation of GAAP financial statements. Additional reporting requirements specific to compiled special purpose financial statements, including contractual basis, are located in AR-C 80A.18–.21.

In a compilation engagement, the client may choose to omit substantially all of the financial statement disclosures. In that case, the accountant's report should include the "Management has elected to omit . . ." paragraph described in AR-C 80A.27 and discussed earlier in this lesson.

Prescribed Forms

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

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

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

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

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

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

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

To illustrate, an entity that uses the cash basis for tax reporting and to prepare its financial statements is required to complete a prescribed form and the instructions to the form do not indicate that a specific financial reporting

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

AR-C 80A requires disclosure of the primary differences between the special purpose framework and GAAP. Prescribed forms rarely ask for such information, and the absence of that disclosure is because the prescribed form is silent on whether disclosures other than those in the form are required. Due to the presumption that the information required by a prescribed form is sufficient to meet the needs of the requesting entity (see the AICPA Guide, Paragraph 2.90), there is no need to mention the absence of that disclosure in the report. However, if the financial statements include departures from the applicable financial reporting framework that are *not* required by the prescribed form, then a departure from the applicable financial reporting framework results.

AR-C 80A does not require compilation reports on financial statements included in a prescribed form to include a paragraph restricting the use of the report to the intended specified parties. However, Paragraph 2.92 of the AICPA Guide indicates that due to the nature of such financial statements and the potential for the report to be misunderstood, accountants may decide to restrict the use of the accountant's compilation report on financial statements prepared in accordance with a prescribed format. The authors recommend restricting the use of reports on prescribed form financial statements.

Prescribed forms often include a preprinted space for the CPA to sign, typically accompanied by reporting language that does not comply with authoritative literature. The authors believe the CPA should not sign the preprinted space but should instead include a reference such as "see the attached accountant's compilation report" and attach the report to the form. This position is consistent with the guidance in the AICPA Guide, Paragraph 2.93.

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

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

Audits. Auditors may be engaged to report on special purpose framework financial information presented in prescribed forms or schedules. However, such forms often prescribe wording for the auditor's report that is unacceptable to auditors because it does not conform to applicable professional reporting standards. For example, the prescribed language of the report may call for assertions by the auditors that are not consistent with their function or responsibility or that the auditors have no basis to make. AU-C 800.24 states that some report forms may be made acceptable by inserting wording, while others may be made acceptable only by complete revision. When a prescribed form calls on auditors to make an assertion that they believe they are not justified in making, they should reword the prescribed form of report or attach a separate report.

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

form usually are not changed, and the accountant's or auditor's report on the statements uses the preprinted titles. The authors agree with that practice based on the presumption that the information required by a prescribed form is sufficient to meet the needs of the body that designed or adopted the form.

Personal Financial Statements

CPAs are frequently asked to provide services in connection with personal financial statements for use in obtaining credit, for income tax planning, retirement planning, gift and estate planning purposes, or for public disclosure by candidates for public office. The term *personal financial statements* refers to financial statements that present the personal assets and liabilities of an individual or group of related individuals (a family). The term does not include financial statements presenting the financial position or results of operations of unincorporated business enterprises such as proprietorships or partnerships.

Lesson 2 provides guidance on preparing personal financial statements using a special purpose framework. Personal financial statements may be prepared on one of the following bases:

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

b. *Modified Cash Basis.* Under the modified cash basis, the pure cash basis is modified to report certain assets and liabilities, generally at the amounts that would be reported under either the historical cost basis or the current value basis.

c. *Historical Cost Basis.* The historical cost basis generally measures the individual's assets and liabilities in accordance with GAAP for reporting entities other than individuals.

d. *Income Tax Basis.* Assets and liabilities under the income tax basis are measured in accordance with the principles the individual uses for federal or other income tax reporting.

The following paragraphs provide guidance for reporting on compiled or reviewed personal financial statements prepared using a comprehensive basis of accounting other than GAAP. *PPC's Guide to Auditor's Reports* discusses reporting on audits of personal financial statements prepared using an estimated current value basis. When audited personal financial statements are prepared using an historical cost basis, the authors recommend that they be reported on in the same manner as financial statements prepared following the guidance in AU-C 800.

Compilation and Review Reports. Compilations and reviews of personal financial statements prepared in conformity with a special purpose framework, like other such engagements, are subject to both the performance and reporting requirements of the SSARS. (*PPC's Guide to Compilation and Review Engagements* provides further guidance on reporting on compilations and reviews of personal financial statements.)

The form and substance of a compilation or review report issued in connection with personal financial statements prepared using a special purpose framework would not differ from such reports issued for commercial entities. Nevertheless, subtle differences in wording are caused by the nature of the engagement. For instance, the financial statement titles in reports on personal financial statements would typically be different [e.g., "Statement of Assets and Liabilities—Income Tax (Historical Cost) Basis" and, if presented, "Statement of Changes in Net Assets—Income Tax (Historical Cost) Basis"]. In addition, the example reports in the AICPA Guide (a) identify the individuals (rather than the company) about whom the financial statements are prepared; (b) note that the representations are those of the individuals instead of management of a company; and (c) in a review, note that the inquiries were made of the individuals and not management.

A discussion earlier in this lesson provided guidance when accountants believe that financial statements prepared in accordance with a special purpose framework contain a departure from the applicable financial reporting framework.

Personal Financial Statements Included in Written Personal Financial Plans. AR-C 70A.01 indicates that the requirements of AR-C 70A do not apply when the accountant prepares personal financial statements to be included in a written personal financial plan that the accountant prepares.

If the financial statements are primarily intended for obtaining credit or other third party use, the client may choose to engage the accountant to *prepare* the financial statements in accordance with the requirements of AR-C 70A or *compile* them in accordance with AR-C 80A. Generally, the decision depends on whether the creditors or other third parties prefer a report on the financial statements submitted to them and on the accountant's willingness to be engaged to prepare financial statements.

Specified Elements, Accounts, or Items of a Financial Statement

Authoritative guidance for reporting on an audit of specified elements, accounts, or items of a financial statement is contained in AU-C 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*. According to that guidance, an accountant can audit a specified element of a financial statement that is presented separately, i.e., not presented as supplementary information with financial statements. Agreed-upon procedures under the guidance in AT-C 215, *Agreed-Upon Procedures 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 80A and AR-C 90A, respectively. AR-C 80A.01 and AR-C 90A.01 indicate that the authoritative guidance applies to engagements to compile and review historical information other than financial statements. In addition, AR-C 80A.A3 and AR-C 90A.A2 list specified elements as types of historical financial information to which the authoritative guidance applies. When the accountant is engaged to compile one or more specified elements, accounts, or items of a special purpose framework financial statement, the report should include the required elements discussed earlier in this lesson (under "Required Elements of Compilation Reports") modified for a specified element engagement. When the accountant is engaged to review one or more specified elements, accounts, or items of a special purpose framework financial statement, the report should include the required elements discussed earlier in this lesson (under "Required Elements of Review Reports") modified for a specified element engagement.

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

SELF-STUDY QUIZ

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

8. Which of the following statements regarding the use of IRS Form 990 is correct?

   a. Charitable organizations are required to use Form 990 as a uniform annual report for both federal and state purposes.

   b. If financial statements and note disclosures included in Form 990 conform with GAAP, auditors would issue an unmodified report.

   c. Auditors should use the regulatory basis report form when Form 990 is used for purposes other than regulatory filings.

   d. Form 990 is not considered a tax return for SSARS purposes.

9. Which of the following statements regarding specific items included in certain prescribed forms is correct?

   a. Accountants are encouraged to perform a review engagement for financial statements included in a prescribed form.

   b. Authoritative literature states that accountants should use unmodified titles for special purpose financial statements.

   c. Prescribed forms often propose wording for the auditor's report that does not conform to professional reporting standards.

   d. The reporting language included near the signature line is generally compliant with authoritative literature.

10. Personal financial statements can be prepared for which of the following type of groups or entities?

    a. Unincorporated business enterprises.

    b. A related group of individuals.

    c. Partnerships.

    d. Proprietorships.

11. In preparing personal financial statements, which basis is measured in accordance with the principles used by the individual for federal income tax reporting?

    a. Modified cash basis.

    b. Historical cost basis.

    c. Cash basis.

    d. Income tax basis.

SELF-STUDY ANSWERS

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

8. Which of the following statements regarding the use of IRS Form 990 is correct? **(Page 145)**

   a. Charitable organizations are required to use Form 990 as a uniform annual report for both federal and state purposes. [This answer is incorrect. Some states allow charitable organizations to use IRS Form 990, "Return of Organizations Exempt from Income Tax," as a uniform annual report for reporting to both state and federal governments, and some of those states require Form 990 to be accompanied by an auditor's report on the financial statements included in the form. However, since only some states allow its use, it is not required.]

   b. **If financial statements and note disclosures included in Form 990 conform with GAAP, auditors would issue an unmodified report. [This answer is correct. If the financial statements included in Form 990 are in conformity with GAAP, including appropriate note disclosures, auditors would issue an unmodified report as illustrated in AU-C 700.]**

   c. Auditors should use the regulatory basis report form when Form 990 is used for purposes other than regulatory filings. [This answer is incorrect. If Form 990 will be used for purposes other than regulatory filings (for example, copies of Form 990 are distributed to contributors or others), the regulatory basis report form is not appropriate. In those cases, auditors should express a qualified or adverse opinion on the financial statements because of the departures from GAAP and, if reasonably determinable, disclose the effects of the material GAAP departures on the financial statements.]

   d. Form 990 is not considered a tax return for SSARS purposes. [This answer is incorrect. In addition to income tax returns, information returns, such as Form 990 and Form 5500, are considered tax returns for purposes of the SSARS.]

9. Which of the following statements regarding specific items included in certain prescribed forms is correct? **(Page 148)**

   a. Accountants are encouraged to perform a review engagement for financial statements included in a prescribed form. [This answer is incorrect. A review engagement generally would not be appropriate for financial statements included in a prescribed form since a review report is not available for financial statements that omit substantially all disclosures, as is often the case with prescribed forms.]

   b. Authoritative literature states that accountants should use unmodified titles for special purpose financial statements. [This answer is incorrect. In some situations, it may be appropriate for accountants to alter the titles on a prescribed form to conform to appropriate statement titles. In that case, the accountant's or auditor's report should refer to the altered titles as they appear on the prescribed form.]

   c. **Prescribed forms often propose wording for the auditor's report that does not conform to professional reporting standards. [This answer is correct. Auditors may be engaged to report on special purpose framework financial information presented in prescribed forms or schedules. However, such forms often prescribe wording for the auditor's report that is unacceptable to auditors because it does not conform to applicable professional reporting standards.]**

   d. The reporting language included near the signature line is generally compliant with authoritative literature. [This answer is incorrect. Prescribed forms often include a preprinted space for the CPA to sign, typically accompanied by reporting language that does not comply with authoritative literature. The authors believe the CPA should not sign the preprinted space but should instead include a reference such as "see the attached accountant's compilation report" and attach the report to the form. This position is consistent with the guidance in the AICPA Guide, Paragraph 2.93.]

10. Personal financial statements can be prepared for which of the following type of groups or entities? **(Page 149)**

    a. Unincorporated business enterprises. [This answer is incorrect. Personal financial statements do not include financial statements presenting the financial position or results of operations of unincorporated business enterprises.]

    b. **A related group of individuals. [This answer is correct. The term personal financial statements refers to financial statements that present the personal assets and liabilities of an individual or group of related individuals (a family).]**

    c. Partnerships. [This answer is incorrect. Personal financial statements do not include those presenting the financial position or results of operations of partnerships.]

    d. Proprietorships. [This answer is incorrect. The financial statements of proprietorships are not included in the type of groups or entities for which personal financial statements can be prepared.]

11. In preparing personal financial statements, which basis is measured in accordance with the principles used by the individual for federal income tax reporting? **(Page 149)**

    a. Modified cash basis. [This answer is incorrect. Under the modified cash basis, the pure cash basis is modified to report certain assets and liabilities, generally at the amounts that would be reported under either historical cost basis or the current value basis.]

    b. Historical cost basis. [This answer is incorrect. The historical cost basis generally measures the individual's assets and liabilities in accordance with GAAP for reporting entities other than individuals.]

    c. Cash basis. [This answer is incorrect. Using the pure cash basis, the only asset reflected on the financial statement is cash, no liabilities, and only cash receipts and disbursements are reported as increases and decreases in net assets.]

    d. **Income tax basis. [This answer is correct. Assets and liabilities under the income tax basis are measured in accordance with the principles the individual uses for federal or other income tax reporting.]**

Lesson 2: Special Entities

INTRODUCTION

The preceding lesson provided guidance on preparing and reporting on special purpose financial statements. Because the guidance was meant to apply to all entities, however, it is necessarily general in nature and does not cover the unique issues certain entities must address. This lesson discusses some of the specialized accounting and reporting problems encountered by various types of entities, including individuals, as follows:

- Information for nonprofit organizations using the cash, income tax, or regulatory bases of accounting.
- Unique issues that estates and trusts generally encounter when using a special purpose framework.
- Information on the use of special purpose frameworks when personal financial statements are prepared, compiled, reviewed, or audited.
- The use of the cash and income tax basis of accounting by professional service entities.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine how use of a special purpose framework could affect financial statements of a nonprofit organization.
- Identify considerations for estates and trusts using special purpose framework financial statements.
- Recognize how individual personal financial statements may be affected when using a special purpose framework.
- Determine how financial statements of a professional service entity may be affected by using a special purpose framework.

CONSIDERATIONS FOR NONPROFIT ORGANIZATIONS

The AICPA Audit and Accounting Guide, *Not-for-Profit Entities* (Nonprofit Audit Guide), recognizes that nonprofit organizations might present their financial statements on a basis of accounting other than GAAP, either because it best meets their needs or to comply with regulatory requirements. The following paragraphs discuss general considerations for the special purpose financial statements for nonprofit organizations and provide specific guidance on preparing such financial statements on the cash, income tax, and regulatory bases.

PPC's Guide to Preparing Nonprofit Financial Statements includes additional information on nonprofit financial statements and a GAAP-basis nonprofit disclosure checklist that may be helpful when identifying disclosures that communicate the substance of required GAAP disclosures.

The FASB ASC Master Glossary includes the following:

- *Net Assets with Donor Restrictions*: net assets subject to donor-imposed restrictions (donors include other types of contributors, including makers of certain grants).
- *Net Assets without Donor Restrictions*: net assets not subject to donor-imposed restrictions (donors include other types of contributors, including makers of certain grants).
- *Underwater Endowment Fund*: an endowment fund, which is donor-restricted, for which the fair value of the fund at the reporting date is less than either the amount of the original gift or the amount required to be maintained by the donor or by law that extends donor restrictions.

In September 2020, FASB issued ASU 2020-07, *Not-for-Profit Entities (Topic 958): Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets*. The amendments expand presentation and disclosure requirements for contributed nonfinancial assets (also referred to as gifts-in-kind). The amendments require that contributed nonfinancial assets be presented as a separate line item in the statement of activities, apart from contributions of cash or other financial assets. In addition, nonprofit organizations must disclose contributed nonfinancial assets received disaggregated by category that depicts the type of assets contributed. Additional disclosures are required for each category of contributed nonfinancial assets. FASB ASU No. 2020-07 is effective for annual periods beginning after June 15, 2021, and interim periods within annual periods beginning after June 15, 2022.

General Considerations

Is Fund Accounting an Acceptable Special Purpose Framework for Nonprofit Organizations? Some accountants have questioned whether they can prepare financial statements using fund accounting (that is, based on accounting principles in effect before the guidance in FASB ASC 958, *Not-for-Profit Entities*, was introduced), and treat it is a special purpose framework and report on the fund accounting basis financial statements in accordance with the AICPA's definition of a special purpose framework. The authors believe that such a presentation does not meet the AICPA's criteria for special purpose frameworks. However, a nonprofit organization can elect to prepare its Form 990 without following the requirements of FASB ASC 958, which typically results in a fund accounting approach. A nonprofit organization making that election could present income tax basis financial statements according to the fund balance approach taken in its Form 990. Information about donor-imposed restrictions and significant changes in those restricted amounts would still be required and could be provided in a note to the financial statements using general descriptions.

Consolidated or Combined Financial Statements. FASB ASC 810-10-15-3 requires *all* reporting entities to follow the consolidation accounting guidance in Topic 810, and FASB ASC 810-10-15-5 states that the application of the guidance in Topic 810 by nonprofit organizations is subject to additional guidance in FASB ASC 958-810. Generally, the reporting entity is required to include in its financial statements the consolidated financial results of all entities in which it has a controlling financial interest.

Topic 810 establishes the presumption that ownership of a majority voting interest gives the reporting entity a controlling financial interest but recognizes that, depending on the facts and circumstances, (a) ownership of a majority voting interest may not give the reporting entity a controlling financial interest and (b) control may be obtained some other way. (Topic 810 uses the terms *controlling financial interest* and *control* interchangeably.)

a. Whether a nonprofit organization has a controlling financial interest in a *for-profit entity* should generally be determined the same way a for-profit entity would determine whether it has a controlling interest in another for-profit entity, except that the Variable Interest Entities Subsections of FASB ASC 810 generally do not apply to reporting entities that are nonprofit organizations.

b. Whether a nonprofit organization controls *another nonprofit organization* should be determined following the guidance in FASB ASC 958-810. Generally, FASB ASC 958-810-25 requires consolidation if the nonprofit organization that is the reporting entity—

   - (1) directly or indirectly owns a majority voting interest or has sole corporate membership in another nonprofit organization and (2) control does not rest with another party *or*

   - (1) has a majority voting interest in the board of a nonprofit organization some way other than through ownership of a majority voting interest or through sole corporate membership, (2) has an economic interest in the other organization, and (3) control does not rest with another party.

FASB ASC 958-810-25-11 through 25-29 clarify whether a nonprofit organization that is a general partner or a limited partner of a for-profit limited partnership or similar legal entity should consolidate that entity. Nonprofit organizations that are general partners are presumed to control a for-profit limited partnership, regardless of the extent of their ownership interest, unless that presumption is overcome. If a limited partnership has multiple general partners, the determination of which, if any, general partner within the group controls and, therefore, should consolidate the limited partnership is based on an analysis of the relevant facts and circumstances. FASB ASC

958-810-25-14 through 25-29 provide guidance for purposes of assessing whether the limited partners' rights might preclude a general partner from controlling a limited partnership. The presumption that a general partner controls the partnership is overcome if the limited partners have either substantive kick-out rights or substantive participating rights. If the presumption is overcome, the general partner accounts for its interest using the equity method of accounting.

FASB ASC 958-810-25-4 encourages, but does not require, consolidation if the nonprofit organization that is the reporting entity has an economic interest in another nonprofit organization and controls it in a way that would not require consolidation. FASB ASC 958-810-25-5 states that the existence of control or an economic interest, but not both, precludes consolidation.

FASB ASC 810-10-45-10 provides the option of presenting combined financial statements for two or more commonly controlled entities. The option is available for all entities, but FASB ASC 958-810-15-3 specifically notes that combined financial statements may be presented for commonly controlled nonprofit organizations.

The authors believe the decision to consolidate or combine entities into a nonprofit organization's financial statements depends on the basis of accounting used.

a. *Cash and Modified Cash Basis.* The authors' views on considering consolidation and combination in preparing pure cash and modified cash basis financial statements are outside the scope of this course, but more information can be found in *PPC's Guide to Cash, Tax, and Other Bases of Accounting*.

b. *Income Tax Basis.* The income tax basis of accounting is defined as the basis of accounting that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements. Therefore, the authors believe income tax basis financial statements should be consolidated only if a consolidated tax return is or will be filed. Since the Form 990 does not permit filing a consolidated return, a nonprofit organization should not issue consolidated tax basis financial statements.

   While consolidated tax returns are not permitted, combined returns are appropriate in certain circumstances. Under income tax law, organizations that establish their tax-exempt status under a group exemption letter and meet certain other requirements can file their annual returns on a group basis using the annual accounting period of their common central (parent) organization. The parent organization is responsible for filing the group return; however, it may not include its own activity in that return. Instead, the parent organization must file a separate annual return for itself. If a group tax return is filed, the authors believe the income tax basis financial statements should present combined results as well since that is the basis of accounting that the entity uses to file its income tax return (AU-C 800.07 and AR-C 60A.07). Accordingly, the authors believe it would be a departure from the income tax basis to present uncombined financial statements in that situation.

Presenting Information about Expenses According to Functional and Natural Classifications. FASB ASC 958-205-45-6 requires all nonprofit organizations to present expenses according to their nature and function in one location (on a statement of activities, a schedule within the financial statement disclosures, or in a separate financial statement). That is, expenses should be presented in a disaggregated manner, detailing functional classifications by their natural expense classifications. For example, major classes of program services and supporting activities should provide a breakdown of expense categories, such as salaries, rent, electricity, supplies, depreciation, etc.

Considerations for Pure Cash Basis Financial Statements

For many nonprofit organizations, financial statements based on cash receipts and disbursements may provide adequate information to users. Nonprofit organizations that commonly report based on cash receipts and disbursements include school activity funds, civic ventures, and political action committees.

Under the pure cash basis of accounting, the financial statements reflect only transactions affecting cash or cash equivalents. The pure cash basis treats all receipts of cash as cash increases and all disbursements of cash as cash decreases. (For example, cash contributions are recorded when received and cash purchases of items such as property and equipment and investments are reflected as expenditures, not assets, when paid.) Donations of noncash assets are not recorded since they do not affect cash or cash equivalents.

Financial Statement Presentation. Following the fair presentation guidance in AU-C 800.17, if the cash amounts reflected in the statement of cash receipts and disbursements include donor-restricted amounts, the pure cash basis statements should provide information about restrictions on cash and significant changes in donor-restricted cash amounts. That could be accomplished through the structure of the statement of cash receipts and disbursements or by disclosing information in a note to the statement.

Considerations for Modified Cash Basis Financial Statements

Nonprofit organizations may use a modified cash basis of accounting. Under that basis of accounting, certain transactions are recorded on the accrual basis and other transactions on the cash basis. AU-C 800.07 and the SSARS describe the modified cash basis of accounting as the pure cash basis incorporating modifications having substantial support. The appropriate modifications and the extent of those modifications are not clearly defined in the authoritative literature; however, the AICPA practice aid, *Accounting and Financial Reporting Guidelines for Cash- and Tax-Basis Financial Statements* (the AICPA Practice Aid), provides nonauthoritative guidance about cash basis modifications. According to the AICPA Practice Aid, modifications to the cash basis of accounting involve using logical and consistent modifications to transactions derived from cash receipts or disbursements. The AICPA Practice Aid also indicates that inconsistent use of a modified cash basis framework would normally result in financial statements that are misleading.

The authors' general recommendations on preparing modified cash basis financial statements are that—

a. the modified cash basis be limited to entities with operations that are oriented toward cash receipts and disbursements, are not significantly influenced by financing activities, and do not have complexities that require significant modifications; and

b. only modifications that are consistent with the cash orientation of operations should be made.

The following paragraphs discuss issues unique to nonprofit organizations that prepare modified cash basis financial statements.

Unconditional Promises to Give. A modification of the pure cash basis to record unconditional promises to give converts contribution revenues to the accrual basis. The authors believe that result is inconsistent with the cash orientation portrayed by the modified cash basis. The AICPA Practice Aid also states such a modification is inappropriate. Nevertheless, if the organization believes the facts and circumstances support such a modification, the authors believe that promises to give that will be collected in more than one year generally should be recorded at their fair value. While accountants differ as to whether the promises to give should subsequently be reduced to reflect a reduction in the amount expected to be received, the authors recommend such adjustments. The authors believe that providing for probable losses on realization of receivables results in the more meaningful amount. Not recognizing such losses results in an artificially high amount and increases the risk that financial statement users will reach the wrong conclusion about the effect the receivables will have on future cash flows. However, if the organization believes the facts and circumstances support electing to record unconditional promises to give but not recognizing such losses, the description of the differences from GAAP in the basis of accounting note should disclose that losses are recognized when realized rather than in the period in which they occur. In addition, the authors believe disclosure of the loss that is expected upon realization of the promises to give would be necessary to keep the statements from being misleading.

Marketable Securities. Organizations may modify the pure cash basis to capitalize payments to acquire marketable securities. However, if significant amounts of securities are donated, only recognizing purchased securities results in a portfolio value that is artificially low. Some accountants believe that donated securities should also be recorded because, presumably, the intent behind presenting securities as assets is to report information to financial statement users about the organization's financial resources. Excluding contributed securities from that presentation would be inconsistent with that intent. Others believe recognizing an increase in net assets from donated securities is inconsistent with the cash orientation portrayed by the modified cash basis. While the authors believe either approach is acceptable, if the organization only capitalizes purchased securities, the authors recommend disclosing the amount of securities donated during the period and the total investments held at year-end, if practicable. The AICPA Practice Aid indicates that while a common cash basis modification is to record the cash purchase of

investments in marketable securities as assets, it is *not* appropriate to record investments for which cash outflows were not involved.

If the cash basis has been modified to record securities, accountants differ as to whether the securities should subsequently be adjusted to their fair value. While some think the modification must result in a carrying amount that is identical to GAAP, other accountants believe that recognizing unrealized changes in fair value does not make sense in some presentations. The AICPA Practice Aid states that subsequent write ups or write downs to fair value to recognize unrealized gains and losses should not be recorded in modified cash-basis financial statements and the asset should remain on the statement of financial position at cost, unless or until the investments become worthless or are sold. In the authors' experience, it is not common to record unrealized changes in the fair value of investments. However, it may be helpful to include information about the fair value of investments in the notes to the financial statements to provide users with information about the effect the investments may have on future cash flows.

Property and Equipment. Property and equipment may be acquired by using internally generated cash, external financing, or a combination of internal and external financing, or through donations. In the authors' opinion, organizations that modify the cash basis to capitalize acquisitions of property and equipment should capitalize all property and equipment acquired. (It may be appropriate to continue charging small items to expense as acquired, however.) However, the AICPA Practice Aid takes a different position, stating that a modified cash basis presentation should not record or depreciate donated capital assets because such a transaction or event does not involve the inflow or outflow of cash. The considerations for whether to record material amounts of donated property and equipment are similar to those discussed above for donated marketable securities. Therefore, while either recording or not recording donated amounts is acceptable in the authors' opinion, if the organization only capitalizes purchased property and equipment, the authors recommend disclosing the amount of property and equipment donated during the period and held at year-end, if practicable.

Financial Statement Presentation. FASB ASC 958-205-05-6 requires the presentation of two classes of net assets: net assets with donor restrictions and net assets without donor restrictions. GAAP presentation requirements should be followed in modified cash basis financial statements, or their substance should be communicated in some other manner. Accordingly, modified cash basis financial statements should either disclose the classes of net assets and present the changes in those classes of net assets or provide other information communicating the substance of those requirements. For example, the substance of the requirements in FASB ASC 958 could be communicated in the notes to the financial statements rather than in the financial statements themselves. The statement of assets, liabilities, and net assets could present total net assets, and the statement of revenues, expenses, and changes in net assets could present the total change in net assets rather than the change in each class of net assets. The notes to the financial statements could then provide additional information about significant donor-imposed restrictions related to net assets and changes in those amounts. In addition, the notes could use actual amounts, estimates, or percentages to communicate information about significant donor-imposed restrictions and changes in those amounts.

Considerations for Income Tax Basis Financial Statements

Authoritative literature describes the *tax basis* as the basis of accounting an entity uses to file its tax return for the period covered by the financial statements. That literature does not provide guidance on whether entities that do not pay income taxes may use the tax basis of accounting, however. The Nonprofit Audit Guide, Paragraph 1.08, acknowledges nonprofit organizations may issue tax basis financial statements.

Nonprofit organizations must file an annual information return on Form 990 (Return of Organization Exempt From Income Tax) with the following exceptions:

- Organizations otherwise required to file Form 990 may file Form 990-EZ (Form 990-EZ is a condensed version of Form 990), rather than Form 990, if their gross receipts during the year are less than $200,000 and their total assets at year end are less than $500,000.
- Organizations with gross receipts that are normally $50,000 or less for the tax year, and certain religious and governmental organizations are not required to file Form 990 or Form 990-EZ. An organization exempt from filing an annual return under the gross receipts test must file an annual notice with the IRS by using

Form 990-N [Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ]. In addition, some of these smaller organizations voluntarily file Form 990 or Form 990-EZ.

- Private foundations file Form 990-PF [Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation], rather than Form 990 or Form 990-EZ. (Certain private foundations may find it appropriate to use an excise tax basis if the users of the financial statements are concerned primarily with net investment income and the amount of excise taxes the organization will have to pay.)

The authors believe nonprofit organizations should base their income tax basis financial statements on the requirements of the form they expect to file. Furthermore, they believe nonprofit organizations that do not file a return with the IRS may *not* prepare income tax basis financial statements since the organizations do not "use or expect to use" the basis of accounting to file an income tax return. For example, the income tax basis is not appropriate for certain religious organizations that are not required to, and do not, file the Form 990 or Form 990-EZ, or for smaller organizations that file only the Form 990-N.

Accounting Methods. An organization may prepare Form 990 using the cash, accrual, or hybrid method. Generally, the method used depends on the accounting method regularly used to keep the organization's books and records. Thus, an organization that keeps its general ledger on the cash basis might use that method for Form 990 rather than the accrual method unless cash to accrual adjustments are few and information needed for the adjustments can be easily gathered. Organizations might consider the following factors when determining which method to use:

- Organizations that file Form 990-T (Exempt Organization Business Income Tax Return) in addition to Form 990 might choose to file Form 990 on the accrual basis since they must report certain income and expenses on the accrual basis for Form 990-T. For example, they must report income produced by inventories on the accrual basis if inventories are a material income-producing factor.
- Some states and local governmental units accept the Form 990 in place of their financial report forms. Organizations that use Form 990 to satisfy state reporting requirements should consider whether the state requires the accrual method to be used to report all amounts. In addition, some states require organizations to report certain transactions, such as contributions, grants, and functional expenses, in accordance with the guidance in FASB ASC 958.

Regardless of the method selected, it generally should be applied consistently from year to year.

Pledges Receivable (Promises to Give). Pledges receivable for income tax reporting purposes may be different from amounts measured under GAAP. (Although FASB ASC 958-310-20 refers to those receivables as promises to give, the Form 990 continues to refer to them as pledges receivable.) The following areas could result in differences:

- Nonprofit organizations are permitted, but not required, to adopt FASB ASC 958-310 for income tax reporting purposes. Accordingly, tax basis financial statements can report pledges receivable at the gross amount the organization expects to receive. Long-term pledges receivable do not have to be measured at fair value (which may involve discounting the pledges to their present value each year) as would be required under GAAP.
- Even if organizations report pledges receivable at fair value for income tax reporting purposes, they are not allowed to reflect the free use of materials, equipment, or facilities as revenues. Consequently, nonprofit organizations should not recognize pledges receivable for those types of transactions in tax basis financial statements. (GAAP requires nonprofit organizations to recognize unconditional promises to give for the free use of materials, equipment, or facilities in the financial statements.)
- If organizations use the cash method for income tax reporting purposes, they would not reflect pledges receivable in the financial statements.

Grants Receivable. The reporting of grants receivable for income tax purposes is similar to the reporting of pledges receivable discussed in the preceding paragraphs. The instructions to Form 990 note that accrual basis organizations following FASB ASC 958-605-30-2, which requires reporting contributions at fair value, can report grants receivable at present value as of the end of the year. As previously discussed, however, organizations are not

required to report grants receivable at fair value for income tax reporting purposes. Accordingly, organizations that do not follow FASB ASC 958-605-30-2 should record the gross amount of grants receivable. If the cash method is used for income tax reporting purposes, organizations should not reflect grants receivable in the financial statements.

Organizations electing to report grants receivable at fair value for purposes of filing Form 990 must determine whether grants are unconditional promises to give, conditional promises to give, or exchange transactions. If grants are determined to be exchange transactions rather than promises to give, organizations should review the terms of the grant agreements to determine when to record the revenue and, after the effective date of FASB ASC 606, account for the transaction in accordance with that guidance. If grants are determined to be promises to give, they should be reported following the guidance in FASB ASC 958-605-25. Conditional grants should not be reported in tax basis financial statements in the same manner that they are not recorded in GAAP basis financial statements.

Investments. Organizations are permitted, but not required, to follow FASB ASC 958 for income tax reporting purposes. The measurement of investments for income tax reporting depends on the type of investment as follows:

- *Investments in Debt Securities and Equity Securities with Readily Determinable Fair Values* generally are carried at cost for tax reporting purposes regardless of their fair value at the end of the period. Accordingly, gains and losses due to the net appreciation in fair value under the income tax basis generally are recognized only when realized through disposal, while gains and losses from dividends and interest are reported during the period earned regardless of when the asset is sold.
- *Equity Investments without Readily Determinable Fair Values*. Tax law generally requires entities to use the cost method and, accordingly, recognize earnings as distributions are received.

Organizations that follow GAAP when reporting investments for income tax reporting purposes should adjust the carrying amount of marketable securities with readily determinable fair values (whether bought or received as a donation) to fair value. The authors believe that any unrealized gains or losses resulting from carrying investments at fair value should be reflected in tax basis statements of revenues, expenses, and other changes in net assets in the same manner in which they are reported on Form 990. Form 990 requires the unrealized change in the carrying amount of marketable securities to be reflected in Part XI, "Reconciliation of Net Assets," and Schedule D, "Supplemental Financial Statements," which reconcile the change in net assets or fund balances from the beginning of the year to the end of the year per the Form 990, and revenue per audited financial statements with revenue per the Form 990, respectively. Accordingly, the authors believe the unrealized gains/losses can be included in the statement of activities in a section for other changes in net assets or fund balances rather than in the excess or deficit of revenues over expenses for the year.

Grants Payable. Under GAAP, nonprofit organizations recognize grants made to others (contributions payable or unconditional promises to give) as expenses in the period the organization funds the grant or agrees to the unconditional obligation to transfer the promised assets in the future. Such grants should be recorded at the fair value of assets given or to be given. Present value techniques may be used to measure the fair value of grants payable in future periods. If a present value method is used, subsequent adjustments of the discount should be recorded as grant expense, not interest expense. However, for income tax reporting purposes, organizations are not required to follow GAAP when reporting grants made to others. Accordingly, in accrual tax basis statements, grants payable may be reported at the amounts promised, without discounting those amounts. Organizations using the cash method for income tax reporting purposes should not recognize grants payable in the financial statements.

Deferred Revenue. The accounting for deferred revenue resulting from exchange transactions under the tax basis does not differ from GAAP. Deferred revenue should include any revenue the organization has received but not yet earned as of the date of the statement of assets, liabilities, and net assets (regardless of whether the cash or accrual tax basis is used). Accordingly, revenue from the sale of goods or services should be deferred for tax purposes if it is received in advance. For example, a child counseling clinic that receives an advance payment from a corporation to provide services in connection with its day care program for employees should defer the revenue and recognize it as services are performed.

The accounting for deferred revenue related to contributions restricted to use in future periods depends on whether the organization follows FASB ASC 958-605 for income tax reporting purposes. (As previously mentioned, the IRS

does not require organizations to follow GAAP when preparing Form 990.) If the organization follows FASB ASC 958-605-45-3, contributions restricted to use in future periods should be recognized in the tax basis statement of revenues, expenses, and other changes in net assets in the period received; no amounts should be deferred. On the other hand, if the organization does not follow FASB ASC 958 for income tax reporting purposes, the authors believe it should report any contributions whose use is donor-restricted to future years as deferred revenue. In addition, the notes to the financial statements should disclose significant changes in deferred restricted contributions.

Net Assets or Fund Balances. Presenting net assets or fund balances in a tax basis statement of financial position depends on whether the organization follows the guidance for financial statement presentation in FASB ASC 958-210 for income tax reporting purposes. If organizations elect to follow that guidance in preparing Form 990, the authors believe information about amounts for the following classes of net assets should be reflected either in the statement of assets, liabilities, and net assets or in the notes to the financial statements:

a. *Net Assets without Donor Restrictions*—represents the portion of a nonprofit organization's net assets that is not subject to donor-imposed restrictions. Other types of contributors, including those that make certain grants, are considered donors for the purpose of this definition.

b. *Net Assets with Donor Restrictions*—represents the portion of a nonprofit organization's net assets that is subject to donor-imposed restrictions. Other types of contributors, including those that make certain grants, are considered donors for the purpose of this definition.

Organizations that do not follow FASB ASC 958-210 for income tax reporting purposes may use fund accounting and report fund balances rather than net assets when preparing Form 990. As noted in AU-C 800.A40, that presentation is also appropriate for income tax basis financial statements of those nonprofit organizations. Fund accounting is a method of maintaining an organization's financial records in which its assets, liabilities, and equity (excess of assets over liabilities) are segregated into several groups or funds. Each fund reflects whether it is subject to donor-imposed restrictions or restrictions imposed internally, such as for board-designated purposes. In effect, each fund is treated as a separate entity with a self-balancing set of accounts for recording assets, liabilities, revenues, expenses, and equity (i.e., fund balance).

Regardless of whether the organization reflects classes of net assets or fund balances in its tax basis financial statements, certain disclosures about restricted amounts will be required.

Contributions. Because the IRS does not require organizations to follow FASB ASC 958 in recording and reporting contributions for income tax reporting purposes, the following differences from GAAP may occur:

- Organizations that do not follow FASB ASC 958-310 are not required to present contributions resulting from pledges receivable that will be collected in future years at fair value (which may involve discounting them to their present value).
- Organizations that do not follow FASB ASC 958-210 may report fund balances for income tax reporting purposes and report contributions as increases in the appropriate fund balances rather than recording them as increases in the appropriate class of net assets.
- The authors also believe organizations that do not follow FASB ASC 958-605 should report any contributions with donor restrictions for use to future years as deferred revenue in the statement of assets, liabilities, and net assets.

Organizations that follow FASB ASC 958-605 for income tax reporting purposes must record contributions as an increase in the appropriate class of net assets, depending on the existence or absence of donor-imposed restrictions. Generally, contributions without donor restrictions would increase *net assets without donor restrictions*, while those with donor restrictions would increase *net assets with donor restrictions*.

Even if organizations choose to follow FASB ASC 958-605 for income tax reporting purposes, the IRS requires different treatment for certain transactions. For example, organizations are not allowed to include donated services or the free use of materials, equipment, or facilities in contribution revenue for income tax reporting purposes. (Organizations that receive contributions of the actual materials, equipment, or facilities rather than their free use, however, should record the donations in tax basis financial statements at their fair value in the period received.)

FASB ASC 958-605-25-16 requires donated services meeting certain criteria to be recognized. In addition, nonprofit organizations record contributions of the free use of materials, equipment, and facilities in the period received at fair value. The authors believe the notes to tax basis financial statements should disclose the nature of donated services and contributions of the free use of materials, equipment, and facilities that have not been reflected in the financial statements.

Contributions for Federated Fundraising Organizations. The instructions to Form 990 require a federated fundraising organization (such as the local United Way) to include in revenue all of the contributions it receives in conjunction with its fund-raising efforts. That requirement applies even if a portion or all of the contributions are designated by donors for a particular organization or organizations. In addition to being reflected as revenues, those amounts should be reflected as grants and allocations expense to the designated organizations. That treatment differs from the GAAP requirements included in FASB ASC 958-605-25. As a general rule, FASB ASC 958-605-25-24 notes that an organization that accepts assets from a donor and agrees to use those assets on behalf of a specified beneficiary or disburse those assets, the return on investment of those assets, or both to that beneficiary, has not received a contribution. Accordingly, FASB ASC 958-605-25-23 requires that organization to recognize a liability to the specified beneficiary when it recognizes the assets received from the donor. The amount should be measured at the fair value of the assets received, with three exceptions to that general rule included in the guidance, as provided in FASB ASC 958-605-25.

Depreciation. For purposes of preparing Form 990, nonprofit organizations generally are not required to use the tax depreciation methods and rules that apply to for-profit entities. Consequently, they may use GAAP or tax depreciation methods to depreciate long-lived assets for tax reporting purposes.

Taxes. Nonprofit organizations are subject to income tax on unrelated business income. Private foundations are also subject to other taxes, including an excise tax on net investment income. Generally, an organization should report taxes in its accrual tax basis financial statements based on the amounts due on the organizations' tax return as of the date of the statement of assets, liabilities, and net assets. If the organization prepares Form 990 on the cash basis, the financial statements should reflect the amount of taxes actually paid during the year. In either case, the deferred method of measuring income taxes prescribed by FASB ASC 740 does not apply to nonprofit organizations using the tax basis of accounting for financial statement reporting purposes.

Financial Statement Presentation. As previously discussed, the IRS does not require nonprofit organizations to follow FASB ASC 958 for income tax reporting purposes. Income tax basis financial statements should either follow GAAP presentation requirements or communicate their substance in some other manner. Consequently, income tax basis financial statements should either disclose the classes of net assets and the changes in those classes of net assets as required by GAAP or provide other information that communicates the substance of those requirements.

The authors believe the intent of the requirements of FASB ASC 958 is to communicate information about significant donor-imposed restrictions on the organization's equity and changes in those amounts with donor restrictions, and, as AU-C 800.A40 notes, the substance of those requirements can be met even if the organization reports information about fund balances. The substance of those requirements can be communicated in the notes to the financial statements rather than in the financial statements themselves. For example, the statement of assets, liabilities, and net assets could present total net assets and the statement of revenues, expenses, and other changes in net assets could present the total change in net assets rather than the change in each class of net assets. (Similarly, if organizations do not follow GAAP in their Form 990, the tax basis statement of assets, liabilities, and fund balances could present total fund balances and the statement of revenues, expenses, and other changes in fund balances could present the total change in fund balances rather than the change in each fund balance.) Additional information about any significant donor restrictions on net assets or fund balances and information about significant changes in those amounts could be provided in the notes to the financial statements using actual amounts, estimated amounts, or percentages.

Tax Basis Financial Statements May Essentially Be GAAP Statements. Organizations that follow FASB ASC 958 and prepare Form 990 on the accrual basis may present tax basis financial statements that are almost identical to GAAP financial statements. Authoritative audit and SSARS guidance does not preclude entities from representing that their financial statements are prepared on the income tax basis in such cases. The guidance addresses using a financial reporting framework other than GAAP rather than focusing on whether the income tax basis of accounting

differs materially from GAAP. Therefore, if the financial results are materially the same under the tax basis and GAAP, the authors believe the users' expectations should be considered when determining how the statements should be described.

Considerations for Regulatory Basis Financial Statements

Some nonprofit organizations maintain their accounting records on a basis identical to, or substantially identical to, that needed to file grant or regulatory reports. The regulatory agencies sometimes prescribe accounting principles for those filings that differ from GAAP. For example, they may require capital expenditures to be expensed rather than capitalized as required by GAAP.

The authors believe nonprofit organizations rarely use the regulatory basis to prepare audited financial statements. That is because AU-C 800 notes that the auditor's report on regulatory basis financial statements should be restricted to use within the organization or filing with the regulatory agency requiring the financial statements. Audited regulatory basis financial statements to be made available for general use (for example, for distribution to donors) were discussed in Lesson 1. The authors believe compiled or reviewed regulatory basis financial statements also are uncommon.

Disclosure Considerations

Basis of Accounting. Audited financial statements should disclose the basis of accounting used to prepare the financial statements and to describe how that basis differs from GAAP. However, authoritative literature does not require the differences between the other accounting basis and GAAP to be quantified in the disclosure. In addition, only significant differences need be described. The authors believe the disclosure only needs to address the substance of the differences between the bases; thus, a detailed discussion of the GAAP treatment of an item is unnecessary. Normally, nonprofit organizations present the disclosure of the basis of accounting at the beginning of the summary of significant accounting policies using a heading such as "Basis of Accounting."

Because auditing and SSARS literature state that the substance of the requirements in FASB ASC 958-205 for financial statement presentation and disclosure should be communicated in special purpose financial statements in some manner, the authors believe it is unnecessary to mention in the basis of accounting disclosure that the organization does not explicitly follow all of the provisions of FASB ASC 958-205. However, organizations may choose to include that fact when disclosing the differences between the other accounting basis and GAAP in some situations (for example, when income tax basis financial statements reflect fund balances and changes in fund balances rather than net assets and changes in net assets). The following is an example disclosure that could be used:

> As permitted for income tax reporting purposes, the Organization has not implemented all of the financial reporting requirements of generally accepted accounting principles. Accordingly, the Organization has not classified the difference between its assets and liabilities as net assets without donor restrictions and net assets with donor restrictions based on the existence or absence of donor-imposed restrictions. In addition, the Organization has not reported the changes in each of those classes of net assets in the accompanying financial statements.

Nevertheless, as previously discussed, information should be provided about net assets subject to donor restrictions and changes in those net assets.

Significant Accounting Policies. Special purpose financial statements should disclose the significant accounting policies used to prepare them. Significant accounting policies include those for which there is a selection from existing acceptable alternatives, principles and methods peculiar to the industry in which the entity operates, and unusual or innovative applications of the applicable financial accounting framework. For example, a nonprofit organization might disclose information about the following alternatives that exist for tax reporting purposes:

- *Organizations May Choose Not to Record Contributions and Pledges Receivable (Promises to Give) in Accordance with FASB ASC 958-310 and 958-605.* If the organization chooses not to follow GAAP for contributions, its policy could be disclosed as follows:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Contributions

The Organization records contributions and grants when they are received. Funds with restrictions by donors, grantors, or other outside parties for specific operating purposes or plant acquisitions are recognized as revenue in the appropriate fund upon the Organization's compliance with the specific restrictions. Amounts received but not yet recognized are recorded as deferred support with restrictions in the accompanying statement of assets, liabilities, and fund balances.

- *Organizations May Choose Not to Follow the Financial Statement Presentation Requirements in FASB ASC 958-205 for Income Tax Reporting Purposes.* The following is an example policy disclosure for an organization that does not comply with the requirements in GAAP for financial statement presentation:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Financial Statement Presentation

The accounts of the Organization are maintained in accordance with the principles of fund accounting. Under fund accounting, resources for various purposes are classified for accounting and reporting purposes into funds established according to their nature and purpose. Separate accounts are maintained for each fund; however, in the accompanying financial statements, funds that have similar characteristics have been combined into fund groups.

- *Organizations May Carry Investments at Cost Rather Than Fair Value.* Reporting investments at cost when GAAP would require fair value can be disclosed through the discussion of the primary differences from GAAP. For example, the basis of accounting disclosure could be expanded to note "the income tax basis differs from GAAP primarily because investments are reported at their cost rather than fair value."
- *Organizations May Calculate Depreciation Using Tax or GAAP Methods.* If the method differs materially from GAAP, that can be disclosed through the discussion of the primary differences from GAAP. Otherwise, the method may be disclosed in a note such as the following:

NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Equipment

Equipment is carried at cost. Depreciation is provided using the straight-line method over prescribed periods.

Disclosure of Income Tax-related Matters. The authors believe that disclosure of an organization's tax-exempt status should be included in the financial statements. Generally, it is included in the summary of significant accounting policies and indicates the Internal Revenue Code Section under which the organization is exempt from federal income taxes. Typically, the disclosure also indicates the nature of any taxes to which the organization is subject.

Tax positions represent positions taken in a previously filed return or expected to be taken in a future return that are reflected in current or deferred income tax assets and liabilities. FASB ASC 740-10-20 notes that the definition of a tax position encompasses a nonprofit organization's status as a tax-exempt nonprofit entity. For nonprofit organizations, tax positions also include:

- Whether the organization's activities are related to its exempt purpose.
- How the organization allocates revenue and expenses between its exempt purpose and unrelated business activities.

FASB ASC 740-10-50-15 requires disclosure of tax years that remain subject to examination by major tax jurisdictions. However, accountants differed as to whether the requirement to disclose open tax years should always

be applied or should only be applied when an entity has significant uncertain tax positions and whether the requirement applied to nonprofit organizations. FASB members indicated that the disclosure of open tax years is only necessary when 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. While including open tax years in the income tax disclosure when there are no uncertain tax positions is not wrong, it creates additional information in the note for a user to read and comprehend that adds little to no value.

Promises to Give (Pledges Receivable). If the financial statements include promises to give (pledges receivable), the notes should communicate the substance of the GAAP disclosure requirements, which differ based on whether the promise to give is unconditional or conditional. The authors believe information about the nature of the promises to give, payment terms, any allowance for uncollectible amounts, and the discount (if applicable) should be provided in the notes to the financial statements.

Investments. The fair value information that would be required by FASB ASC 320-10 and FASB ASC 321-10 is not relevant to a company's tax basis financial statements since investments are carried at cost in its tax basis balance sheet. Similarly, the fair value information required by FASB ASC 820-10, 958-320, and 958-321 would not be relevant to a nonprofit organization's financial statements if investments are carried at cost. However, some organizations choose to include limited disclosures related to fair values and gross unrealized holding gains and losses in the notes to the financial statements.

If marketable securities are carried at fair value, the disclosures similar to those required by FASB ASC 820-10-50, 958-320-50, and 958-321-50 should be made.

Deferred Amounts. In cash basis financial statements modified to record deferred revenue, deferred revenue typically will consist solely of revenue from exchange transactions that has been received but not yet earned. Although GAAP would require no specific disclosures for deferred revenue resulting from exchange transactions, the authors believe it should be segregated from other liabilities in the financial statements if it is material.

Tax basis financial statements also may have deferred revenue related to contributions restricted to use in future periods. Because GAAP requires revenue related to restricted contributions to be recognized in the statement of activities in the period received, no amounts are deferred in GAAP financial statements. However, GAAP financial statements disclose changes in restricted amounts through the presentation on the statement of activities. Similar information should be provided in special purpose financial statements. Thus, information about significant changes in deferred revenue related to contributions restricted to use in future periods should be provided in the notes to the financial statements using either actual amounts, estimated amounts, or percentages.

Net Assets and Fund Balances. FASB ASC 958-205-05-6 requires the amounts for each of the two classes of net assets and total net assets to be reported on the face of a GAAP basis statement of financial position. In addition, FASB ASC 958-210-50-3 requires the dollar amount, description, and purpose of the different types of restrictions on how and when, if ever, net assets may be used to be disclosed either on the face of the statement of financial position or in the notes to the financial statements. Any additional limitations (such as those that are board designated) placed on net assets without donor restrictions should also be disclosed.

Special purpose financial statements should follow the GAAP disclosure requirements or provide information that communicates the substance of the GAAP requirements. Thus, the authors believe a statement of assets, liabilities, and net assets prepared on the modified cash basis could include a total for net assets. Likewise, a statement of assets, liabilities, and net assets (or fund balances) prepared on the income tax basis could include a total for net assets (or fund balances). Information about any significant donor-imposed restrictions on net assets or fund balances and significant changes in those amounts should then be provided in the notes to the financial statements using actual amounts, estimated amounts, or percentages.

FASB ASC 958-205-45-13 states that endowment funds are included in either net assets without donor restrictions or net assets with donor restrictions based on any donor-imposed restrictions. A board designated endowment fund (sometime referred to as a quasi-endowment) would not be considered to have a donor-imposed restriction and thus its net assets would be considered net assets without donor restrictions. FASB ASC 958-205-45-13D through 45-13F explain how to classify endowment funds subject to UPMIFA. FASB ASC 958-205-50-1A and 50-1B include the disclosure requirements related to endowment funds. Information communicating the substance of these

required disclosures should be included in modified cash basis and income tax basis financial statements that include endowment funds.

Donated Services. GAAP requires disclosing the activities or programs for which donated services were used, the nature and extent of those services, and the amount recognized as revenue during the period. FASB ASC 958-605-50-1 also encourages disclosure of the fair value of donated services received but not recognized as revenues in the financial statements, if practicable. Donated services are not reflected in revenue in income tax basis financial statements, and cash basis financial statements generally are not modified to reflect those amounts. Thus, the disclosure of the amount recognized as revenue during the period typically will not be applicable to tax or cash basis financial statements. However, the authors believe that organizations should disclose information in the notes to the financial statements about (a) the nature and extent of any services donated to them during the period and (b) the activities or programs for which the donated services were used. The fair value of those donated services also may be disclosed, but that disclosure is not required.

Donated Use of Nonfinancial Assets. In GAAP financial statements, the donated use of nonfinancial assets such as materials, equipment, or facilities is presented as a separate line item in the statement of activities, apart from contributions of cash and other financial assets. FASB ASC 958-605-50-1A requires a note disclosure of the disaggregation of the amount each type of contributed nonfinancial assets, and to also include the following information for each category: (a) qualitative information about whether the contributed nonfinancial assets were either monetized or utilized during the reporting period and, if utilized, a description of the programs and other activities in which those assets were used; (b) the nonprofit organization's policy (if any) about monetizing rather than utilizing the contributed nonfinancial assets; (c) a description of any related donor-imposed restrictions; (d) a description of the valuation techniques and inputs used to arrive at a fair value measure in accordance with FASB ASC 820-10-50-2(bbb)(1); at initial recognition; and (e) the principal market (or most advantageous market) used to arrive at a fair value measure if it is a market in which the recipient nonprofit organization is prohibited by a donor-imposed restriction from selling or using the contributed nonfinancial assets. Similar to donated services discussed in the preceding paragraph, however, the donated use of nonfinancial assets is not reflected in revenue in income tax basis financial statements, and generally is not included in modified cash basis financial statements. However, the authors believe information about the free use of those items should be provided in the notes to tax and cash basis financial statements to communicate the substance of the GAAP disclosure requirements.

Functional Expenses. FASB ASC 958-720-45-2 requires a nonprofit organization's GAAP financial statements to provide information about expenses reported by their functional expense classification. In addition, FASB ASC 958-720-45-15 requires all nonprofit organizations to report expense information in one location (on the statement of activities, a schedule in the notes, or in a separate financial statement). The expenses should be presented in a disaggregated manner, detailing functional classifications by their natural expense classifications. For example, major classes of program services and supporting activities should provide a breakdown of expense categories, such as salaries, rent, electricity, supplies, depreciation, etc.

Similar information about functional classifications should be disclosed in special purpose financial statements. However, as AU-C 800.A25–.A29 and .A35 note, the substance of the disclosure requirements may be communicated in the notes to the financial statements using estimates or percentages rather than the actual amounts. For example, the note to the financial statements might disclose that approximately 80% of the organization's expenses relate to program services, 15% to supporting services, and 5% to fundraising activities.

SELF-STUDY QUIZ

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

12. In reference to consolidated financial statements, generally FASB ASC 958-810-25 requires consolidation in which of the following circumstances?

    a. The reporting entity owns a majority voting interest and control rests with another party.

    b. The reporting entity owns a majority voting interest and control does not rest with another party.

    c. The reporting entity owns a minority voting interest and control rests with another party.

    d. The reporting entity owns a minority voting interest and control does not rest with another party.

13. When selecting a special purpose framework, which consideration correctly applies to a nonprofit organization?

    a. The regulatory basis is commonly used and helpful for organizations that use grants.

    b. The income tax basis cannot be used because nonprofit organizations are exempt from paying taxes.

    c. As long as modifications have substantial support, nonprofit organizations can use the modified cash basis.

    d. Pure cash basis financial statements do not provide enough information to be commonly used by nonprofit organizations.

14. Which of the following nonprofit organizations qualifies for an exception from filing an annual information return on the standard Form 990?

    a. Instant Action has annual gross receipts of $300,000 and total assets of $750,000 at year-end.

    b. Jumpstarters normally has annual gross receipts ranging between $60,000 and $70,000.

    c. Charity Committee has annual gross receipts that average $90,000 per year.

    d. The Kirkland Group is structured as a private foundation.

15. Which of the following statements best describes disclosure considerations for financial statements prepared on the income tax basis?

    a. Income tax basis financial statements do not need to include details about promises to give.

    b. Fair value information required by FASB ASC 320-10 and 321-10 is disclosed in the statement notes.

    c. Income tax basis financial statements do not include donated services in revenue.

    d. Amounts for both net assets classes may be omitted from tax basis financial statements.

SELF-STUDY ANSWERS

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

12. In reference to consolidated financial statements, generally FASB ASC 958-810-25 requires consolidation in which of the following circumstances? **(Page 156)**

    a. The reporting entity owns a majority voting interest and control rests with another party. [This answer is incorrect. Per the text, this generally would not be the correct combination of criteria to require consolidation under FASB ASC 958-810-25.]

    b. **The reporting entity owns a majority voting interest and control does not rest with another party. [This answer is correct. Whether a nonprofit organization controls another nonprofit organization should be determined following the guidance in FASB ASC 958-810. Generally, FASB ASC 958-810-25 requires consolidation if the nonprofit organization that is the reporting entity (1) directly or indirectly owns a majority voting interest or has sole corporate membership in another nonprofit organization and (2) control does not rest with another party.]**

    c. The reporting entity owns a minority voting interest and control rests with another party. [This answer is incorrect. According to the text, a different combination of criteria would generally need to be met to require consolidation as per FASB ASC 958-810-25.]

    d. The reporting entity owns a minority voting interest and control does not rest with another party. [This answer is incorrect. As per the text, FASB ASC 958-810-25 would require a different combination of criteria for consolidation.]

13. When selecting a special purpose framework, which consideration correctly applies to a nonprofit organization? **(Page 158)**

    a. The regulatory basis is commonly used and helpful for organizations that use grants. [This answer is incorrect. The authors of this course believe nonprofit organizations rarely use the regulatory basis to prepare audited financial statements. That is because AU-C 800 notes that the auditor's report on regulatory basis financial statements should be restricted to use within the organization or filing with the regulatory agency requiring the financial statements.]

    b. The income tax basis cannot be used because nonprofit organizations are exempt from paying taxes. [This answer is incorrect. Although authoritative literature does not provide guidance on whether entities that do not pay income taxes may use the income tax basis of accounting, the Nonprofit Audit Guide, Paragraph 1.08, acknowledges that nonprofit organizations may issue tax basis financial statements.]

    c. **As long as modifications have substantial support, nonprofit organizations can use the modified cash basis. [This answer is correct. Nonprofit organizations may use a modified cash basis of accounting. Under that basis of accounting, certain transactions are recorded on the accrual basis and other transactions on the cash basis. AU-C 800.07 and the SSARS describe the modified cash basis of accounting as the pure cash basis incorporating modifications having substantial support.]**

    d. Pure cash basis financial statements do not provide enough information to be commonly used by nonprofit organizations. [This answer is incorrect. For many nonprofit organizations, financial statements based on cash receipts and disbursements may provide adequate information to users. Nonprofit organizations that commonly report based on cash receipts and disbursements include school activity funds, civic ventures, and political action committees.]

14. Which of the following nonprofit organizations qualifies for an exception from filing an annual information return on the standard Form 990? **(Page 159)**

    a. Instant Action has annual gross receipts of $300,000 and total assets of $750,000 at year-end. [This answer is incorrect. Organizations otherwise required to file Form 990 may file Form 990-EZ if their gross receipts during the year are less than $200,000 and total assets at year-end are less than $500,000. However, Instant Action has amounts too large to qualify to use Form 990-EZ, so it must file Form 990.]

    b. Jumpstarters normally has annual gross receipts ranging between $60,000 and $70,000. [This answer is incorrect. Organizations with gross receipts under a certain threshold for the tax year are not required to file Form 990 or Form 990-EZ. However, Jumpstarters' gross receipts are above the threshold and thus are too high to meet the standard Form 990 exception.]

    c. Charity Committee has annual gross receipts that average $90,000 per year. [This answer is incorrect. Charity Committee's gross receipts are above the threshold required to be excepted from filing an annual information return on Form 990.]

    d. **The Kirkland Group is structured as a private foundation. [This answer is correct. Private foundations file Form 990-PF, rather than the standard Form 990, so it qualifies for the exception.]**

15. Which of the following statements best describes disclosure considerations for financial statements prepared on the income tax basis? **(Page 167)**

    a. Income tax basis financial statements do not need to include details about promises to give. [This answer is incorrect. If the financial statements include promises to give (pledges receivable), the notes should communicate the substance of the GAAP disclosure requirements. Accordingly, information about payment terms, any allowance for uncollectible amounts, and the discount (if applicable) would be provided in the notes to the financial statements.]

    b. Fair value information required by FASB ASC 320-10 and 321-10 is disclosed in the statement notes. [This answer is incorrect. The fair value information that would be required by FASB ASC 320-10 and FASB ASC 321-10 is not relevant to a company's tax basis financial statements since investments are carried at cost in its tax basis balance sheet.]

    c. **Income tax basis financial statements do not include donated services in revenue. [This answer is correct. Donated services are not reflected in revenue in income tax basis financial statements, and cash basis financial statements generally are not modified to reflect those amounts. Thus, the disclosure of the amount recognized as revenue during the period typically will not be applicable to tax or cash basis financial statements.]**

    d. Amounts for both net assets classes may be omitted from tax basis financial statements. [This answer is incorrect. FASB ASC 958-205-05-6 requires the amounts for each of the two classes of net assets and total net assets to be reported on the face of a GAAP basis statement of financial position. Special purpose financial statements should follow the GAAP disclosure requirements or provide information that communicates the substance of the GAAP requirements.]

ACCOUNTING FOR ESTATES AND TRUSTS

Determining the Basis of Accounting

Estates and trusts present an accountability of funds in the form of financial statements, which normally are intended to meet the requirements of a probate court or the beneficiaries of the estate or trust. The financial statements (referred to in this lesson as fiduciary financial statements) may be presented on a GAAP basis or a special purpose framework. The presentation, disclosure, and reporting issues for estates and trusts are uniquely different from those for a typical corporate entity. Unfortunately, little authoritative guidance exists on the subject of estate and trust financial statements. This section presents information on issues relating to accounting and reporting for estates and trusts when the entity chooses to use a special purpose framework as its applicable reporting framework. More in-depth guidance is included in *PPC's Guide to Accounting and Reporting for Estates and Trusts*.

GAAP. The determination of GAAP for fiduciary accounting is difficult because—

a. an authoritative body such as the FASB has not issued a pronouncement (or other guidance) dealing with fiduciary accounting. Likewise, nonauthoritative literature issued by the AICPA does not directly address fiduciary accounting.

b. the determination of how to account for an estate or trust normally depends upon, or is subject to, the proper interpretation of a governing document (the will or trust agreement) and the laws of the state having jurisdiction.

The following information addresses existing practices and literature that the authors believe can be identified as generally accepted for fiduciary accounting.

a. *The Uniform Principal and Income Acts.* The starting point when surveying accounting practices that apply to fiduciary engagements is to review the accounting rules and conventions required by state law. Fortunately, most states have adopted, in some form, the basic accounting conventions of the Uniform Principal and Income Act (UPIA) or the Uniform Fiduciary Income and Principal Act (UFIPA). It should be noted that many states only adopted parts of the UPIA or have adopted the entire UPIA but modified portions of it. Thus, accountants need to be familiar with the UPIA and other governing state laws when engaged to prepare an accounting of an estate or trust. (As of the date of this course, six states have enacted the UFIPA, and three other states have introduced the legislation. The UFIPA and update information on state adoption are available at **www.uniformlaws.org**.)

   According to the UPIA and UFIPA, the first source of accounting authority for a fiduciary transaction is the governing document (the will or trust agreement). The governing document may or may not explicitly provide for all allocations, instead granting the fiduciary discretion as to how some or all allocations are made—even if the fiduciary's allocation produces a result different from state law. Any allocation must be done impartially. If the governing document is silent and does not grant the fiduciary discretion, the provisions for state law must be followed. If the governing document is silent and does not grant the fiduciary discretion and state law is silent, then any inflow or outflow should be charged to principal.

   The UPIA and UFIPA also discuss in detail how to account for various receipts and expenditures and determine which transactions normally affect principal balances versus income. This guidance applies to those transactions accounted for under state law, i.e., where the governing document is silent and no provision exists for fiduciary discretion.

   The UPIA and UFIPA create an interesting paradox—they establish a body of accounting guidance that can be consistently applied in most states; but, by making the governing document the overriding authority for each fiduciary engagement, they create an inconsistent situation where potentially no two estates or trusts are accounted for in the same manner.

b. *State Statutes.* The state's version of the Uniform Principal and Income Act or Uniform Fiduciary Income and Principal Act (see discussion in item a.), other laws relating to allocation of principal and income, and statutes relating to fiduciary entities (e.g., state probate code and trust law), play a large part in determining what is *generally accepted* in a particular state. In most instances, state statutes, and not the will or trust

agreement, define accounting and reporting requirements. Although a basis of accounting may not be formally specified, state statutes often use language such as *receipts*, *cash receipts*, *receipts during the period*, and *cash disbursements*. As discussed later in this section, many practitioners believe, absent requirements in the governing document to the contrary, that the language adopted in state statutes establishes GAAP for such accountings.

c. *Committee on National Fiduciary Accounting Standards.* The Committee developed a basic objective of fiduciary accounting and six fiduciary accounting principles, which are sometimes referred to as the uniform principles. Many states have incorporated the uniform principles into state law. The fiduciary accounting principles provide guidance for preparation of statements and address the following accounting issues:

   (1) The fundamental objective of an account should be to provide essential and useful information in a meaningful form, as simply as possible, to the parties interested in the accounting process.

   (2) Accounts should be stated in a manner that is understandable by persons who are not familiar with practices and terminology peculiar to the administration of estates and trusts.

   (3) A fiduciary account should begin with a concise summary of its purpose and content.

   (4) A fiduciary account should contain sufficient information to put the interested parties on notice as to all significant transactions affecting administration during the accounting period.

   (5) A fiduciary account should include both carrying values representing the value of assets at acquisition by the fiduciary and current values at the beginning and end of the accounting period.

   (6) Gains and losses incurred during the accounting period should be shown separately in the same schedule.

   (7) The account should show significant transactions that do not affect the amount for which the fiduciary is accountable.

   The Committee report also included a "Model Executor's Account" and a "Model Trustee's Account" that illustrate the application of the fiduciary accounting principles in a "summary of account" format.

Many accountants believe the primary accounting conventions that comprise generally accepted fiduciary accounting principles are as follows:

a. The assets under the fiduciary's (executor/trustee) control should be accounted for according to the governing document and/or state law. Normally, such accounting pertains to the determination of transactions that affect the interests of various classes of beneficiaries.

b. Assets over which the fiduciary has no management and control, either through contracted arrangements, operation of law, or lack of exercise of management and control by the fiduciary are excluded from any statements prepared. (Note that this would not necessarily be true of financial statements prepared on the income tax basis.)

c. Assets are not recognized until there is passage of legal title, other indications of ownership, or the asset has been converted to cash. Thus, receivables are not recognized unless there is written evidence of their existence. Accrued interest and dividends may be assets for estate tax purposes, but not for fiduciary accounting purposes.

d. Liabilities existing at the date of death and disbursements are not recognized until there is a payment by transferring cash or another asset of the entity. That is a departure from the usual practice (even in a tax or cash basis entity) of recognizing liabilities when assets are acquired. For example, the assets of an estate might include a farm with a related mortgage payable. The financial statements would disclose the current value of the farm but not the related mortgage debt. Many accountants are uncomfortable with that accounting convention and encourage the executor/trustee to disclose in a note (or parenthetically on the face of the statement) the related debt. For trusts, liabilities related to assets transferred to the trust are generally recorded.

e. There is one principal financial statement, often called the "Summary of Account," that is supported by subsidiary schedules and notes explaining items on the statement. That statement most closely resembles the statement of cash flows as included in the financial statements of most commercial entities. It begins with assets on hand at the beginning of the period, shows receipts and disbursements during the period, and ends with assets on hand at the end of the period.

f. Assets are reported in the "Summary of Account" at *fiduciary acquisition value*, which represents market value on the date assets are transferred to the fiduciary (or cost for assets subsequently purchased). Current (market) value as of the date the "Summary of Account" is prepared is also disclosed.

Exhibit 2-1 lists some of the characteristics of fiduciary accounting for GAAP purposes. A detailed discussion of GAAP reporting and disclosure requirements for trusts and estates is beyond the scope of this course. For further guidance, accountants may refer to *PPC's Guide to Accounting and Reporting for Estates and Trusts*.

Exhibit 2-1

Characteristics of GAAP Fiduciary Financial Statements[a]

Characteristics	Unique Attributes
Basis of valuing assets.	The normal valuation basis for the assets of an estate or trust is *fiduciary acquisition value*, which generally is market value on the date assets are transferred to the fiduciary (date of death or date of transfer to trust).[b] Current (market) values as of the date of the financial presentation are also disclosed.
Separate accounting for principal and income.	In fiduciary accounting, there are two classes of owners—*remainder beneficiaries* and *income beneficiaries*. Their interests may be different (and perhaps opposing) since the income beneficiaries are primarily interested in maximizing income and the remainder beneficiaries are primarily interested in safety and growth.
Lack of internal consistency in accounting for principal or income.	The determination of how to account for principal[c] or income[d] of an estate or trust normally depends on the terms of each unique governing document (will or trust document) or on the requirements of state law. Consequently, there can be a lack of consistency between individual estates or trusts in the accounting for transactions that affect principal or income. That contrasts to the relative consistency of accounting for most transactions of commercial entities.

Characteristics	Unique Attributes
The financial presentations of an estate do not include liabilities.	The executor of an estate is not responsible for recording liabilities; he is only responsible for assets. Creditors are responsible for filing claims against the estate, but such claims are not reflected as liabilities on the financial statements. Likewise, notes payable secured by a deed of trust on assets of an estate are not reflected as liabilities. Only actual cash payments on creditor claims or debt are reflected in the financial statements under the disbursement or other appropriate caption.
The financial presentations of an estate or trust are normally intended for only a limited number of users.	Although some fiduciary accountings are a matter of public record, they are rarely requested by or submitted to third parties. Instead, such accountings are merely a part of the legal papers in an accounting proceeding, served on the specific parties interested in the particular estate or trust being settled.

Notes:

[a] While this table represents characteristics and unique attributes of GAAP financial statements presented in a Summary of Account style of presentation, there is a considerable amount of debate in practice about the appropriate characteristics that comprise GAAP basis traditional financial statement presentations. A Summary of Account is a format of financial presentations generally filed with a court of law that reflects the transactions relating to estate or trust assets for which the fiduciary is responsible.

[b] In other words, *carrying value* is the value of the asset at the time the fiduciary acquired the asset.

[c] Principal, or corpus, is the property set aside by the owner for eventual delivery to one or more remaindermen (for example, proceeds from the sale of assets, dividends, insurance proceeds, royalties from depletable resources, allowances for depreciation, and other receipts that will be distributed to the remaindermen).

[d] Income is the earnings from the use or investment of principal (for example, dividends, rents, royalties, and other receipts from principal).

Presentations in Accordance with the Terms of an Agreement. Many accountants believe a uniform body of knowledge that could be described as GAAP for fiduciary accounting does not exist. They point to the inconsistent application of the Uniform Principal and Income Act or Uniform Fiduciary Income and Principal Act and the wide assortment of financial presentations found in practice. They believe that because of the ability of the governing document (i.e., the will or trust agreement) to establish unique accounting conventions for each estate or trust, fiduciary financial statements are prepared in accordance with the terms of an agreement.

The authors believe that use of a basis of accounting specified in an agreement is an acceptable reporting alternative only when the governing document actually specifies a basis of accounting. Financial statements prepared in conformity with an agreement that specifies the basis of accounting meet the definition of the contractual basis in AU-C 800 and the SSARS.

Audit Reports. Auditors should report on the conformity of such statements with the contractual agreement following the guidance in AU-C 800 for special purpose financial statements. Lesson 1 provided information on those requirements for issuing an audit report on special purpose financial statements, and additional requirements that should be followed when reporting on contractual basis financial statements.

Compilation and Review Reports. Accountants performing a compilation or review on the statements discussed above should report on such statements following the special purpose framework (contractual basis) reporting requirements of AR-C 80A and AR-C 90A. Lesson 1 provided information on the general reporting requirements for

compilation and review special purpose financial statements, and additional requirements that should be followed when reporting on such statements using the contractual basis.

Prescribed Form. Another approach used by some accountants is to view a fiduciary accounting engagement (especially those concerning estate accountings) as a prescribed form engagement. A prescribed form engagement presents the financial statements on a preprinted form designed by the body using the statements. Such forms do not typically call for GAAP measurements or disclosures. An estate or trust might be asked to submit financial statements on a prescribed form that does not call for or provide space for all the matters or disclosures otherwise required by GAAP. The accountant's ability to provide financial statements in such a format depends on the level of service for which the accountant was engaged. A form designed or adopted by the entity whose financial statements are to be compiled is not considered to be a prescribed form. For instance, a reporting package designed by a bank trust department for use in reporting financial information about trust balances and activities relating to its clients is not a prescribed form.

Reporting on prescribed forms in general was discussed in more detail in Lesson 1. Additionally, *PPC's Guide to Compilation and Review Engagements* and *PPC's Guide to Accounting and Reporting for Estates and Trusts* provide further guidance on prescribed forms.

Cash Basis. Some accountants argue that while an adequate body of accounting conventions does exist for accountings of estates and trusts, it is incorrect to label them as GAAP. They believe the term GAAP implies the use of accrual accounting. But financial statements of an estate or trust do not recognize liabilities. Accordingly, they prefer to label the basis of accounting as the cash basis. In addition, in most instances, state statutes, and not the will or trust agreement, are used to define accounting and reporting requirements. Although a basis of accounting may not be formally specified, state statutes often use language such as "cash receipts" and "cash disbursements," etc. Many practitioners argue that such language indicates that the cash or modified cash basis of accounting *is* GAAP for fiduciary entities. If such basis is the predominant practice used in a given state, the authors believe there is a strong argument that the cash or modified cash basis of accounting constitutes the prevalent practice and may be considered GAAP for fiduciary entities. If the practitioner believes, based on appropriate circumstances, that the modified cash basis of accounting is GAAP, such financial presentations should be reported as GAAP financial statements.

For some trusts and estates, fiduciaries, beneficiaries, or other parties also may request or require an accounting of the trust or estate based on the cash basis of accounting using a more traditional financial statement presentation (instead of the summary of account format). Considerations for pure cash basis and modified cash basis financial statements are discussed later in this section.

Tax Basis. Financial statements prepared in accordance with the federal income tax basis are prepared on a special purpose framework, according to AU-C 800 and the SSARS. The authors believe that entities filing returns with the IRS (including estates and trusts) may prepare their financial statements on the tax basis of accounting, and accountants may report on those financial statements as tax basis financial statements. However, the authors caution that the federal income tax return of an estate or trust could include assets not recognized by the administrable estate and not included in financial statements prepared in accordance with the previously mentioned reporting alternatives. Guidance later in this section discusses considerations for income tax basis presentations in further detail.

The Authors' Recommendations. Because authoritative literature does not directly address fiduciary accounting, the authors believe accountants have latitude when selecting the basis of accounting to use for fiduciary accounting. In the authors' opinion, each alternative discussed in the preceding paragraphs, at the present stage of development of authoritative literature, can be justified under the appropriate circumstances. However, due to the nature and purpose of fiduciary accounting, accountants need to carefully consider the selection of a basis of accounting. The authors believe some choices of accounting basis are generally more appropriate than others. A special purpose framework presentation may be useful, particularly when preparing more traditional financial statement presentations, as discussed below.

The version of the Uniform Principal and Income Act or the Uniform Fiduciary Income and Principle Act adopted by the state, other laws relating to allocation of principal and income, and state statutes relating to fiduciary entities, play

a large part in determining what is "generally accepted" in a particular state. When the governing document is silent about a required basis of accounting, state statutes, and not the will or the trust agreement, defines the accounting and reporting requirements. If the governing document is silent, the authors believe practitioners should be cautious when considering any accounting basis or format that does not comply with the governing document, or state law. They should be prepared to justify to the courts, beneficiaries, and other interested parties why their accounting is not in compliance with either the applicable requirements of the governing document or the state.

If no reporting requirements are included (or implied) in the governing document or state law, that increases the options available to practitioners in choosing a basis of accounting for reporting purposes. While the modified cash basis, whether labeled as GAAP or a special purpose framework, is frequently used in practice, if the governing document or state law do not preclude accrual or tax basis, the accrual or tax basis of accounting may still be used. However, as a practical matter, use of the tax basis would be rare in accountings for the court since the court is generally not interested in tax basis information. Likewise, accrual-based statements would be of limited usefulness to a court of law. When selecting a basis of accounting, it is extremely important for accountants to understand how fiduciary accounting will be used.

Presentation Format

Summary of account format statements usually are prepared to comply with the requirements of a court of law. Some of the reasons that more traditional financial statements are generally not prepared include the following:

- *The Lack of Clear-cut Guidance on GAAP and Acceptable Reporting Alternatives.* As previously discussed, the lack of guidance and various viewpoints concerning GAAP often limit fiduciary reporting to compliance with court and tax filing requirements.
- *The Nature of the Trust or Estate.* Estates usually are of short duration (generally two years). Thus, financial reporting generally is limited to compliance with court and tax filing requirements.
- *The Goals of Preservation of Corpus (Principal) and/or Maximizing Distributions to Beneficiaries.* As the *owners* of the trust or estate assets, the interests of the beneficiaries may be best served by minimizing expenses and maximizing income and principal. As a result, resources will not be allocated to any optional reporting formats.
- *Fiduciary Accountings Are Rarely Requested by or Submitted to Third Parties.* As a result, financial reporting may be limited to legal filings necessary to settle the estate or trust.

The authors believe, however, that more traditional financial statements (that is, balance sheet and operating statement format) may be appropriate, although they appear less frequently in practice. Depending on the governing document and the requirements of state law, such presentations often are presented in the form of more traditional financial statements for the following reasons:

a. *The Governing Document or State Law May Require Additional Accountings for Trusts or Estates.* The fiduciary is first required to comply with the governing trust or estate document, such as a trust instrument or will. If the governing document is silent concerning reporting requirements, and does not grant the trustee discretion, the accountant follows the requirements established by state or local law. If state law is silent, then any inflow or outflow would be charged to principal.

b. *The Current and Remaindermen Beneficiaries May Require or Request Additional Information about the Management of the Estate or Trust.* As discussed in Exhibit 2-1, only in fiduciary accounting are there two classes of owners—remainder beneficiaries and income beneficiaries. In addition, their interests may be different (and perhaps opposing) since the income beneficiaries are primarily interested in maximizing income and the remainder beneficiaries are primarily interested in safety and growth of the principal (corpus).

c. *An Accounting for Estate or Trust Assets in a Format That Is More Similar to GAAP Presentations for Commercial Entities May Be More Useful.* The summary of account format, which is sometimes called a *charge and discharge statement*, reflects the transactions relating to the estate or trust assets for which the fiduciary is responsible. In essence, fiduciary accounting can be viewed as *responsibility* accounting. The

summary of account format does not purport to present financial position and results of operations in a manner that resembles traditional GAAP or other financial reporting framework presentations for other entities. Its focus is on the assets received by the trust or estate, the income transactions related to those assets, expenses, and disbursements to beneficiaries, and the remaining assets at the end of the reporting period. A point of confusion for many users is that the balance sheet (statement of assets) of an estate does not include liabilities, including liabilities secured by estate assets. In addition, the normal valuation basis for the assets of an estate or trust is current value, as of the date of death (i.e., basis is stepped up at the date of death), which differs from the historical cost measurement of most assets of commercial entities.

d. *The Nature of the Trust.* Since a trust may have a long-term existence, the trust agreement and/or the trustee may wish to present a more complete financial presentation of the trust's financial position and results.

e. *Nature of Assets and Activities.* If the trust or estate owns a proprietorship business, the individual assets and liabilities of the business are not reflected in the trust or estate financial statements. Instead, the trust or estate's interest in the business is recorded as a single line item and any profits distributed to the fiduciary are reflected as income, and distributions of profit to income beneficiaries are considered distributions of income. Similarly, only the fiduciary's stock in a business and associated dividends are reported in the financial statements.

Considerations for Pure Cash Basis Financial Statements

In AU-C 800 and the SSARS, the "cash basis of accounting" refers to the "pure" or "unmodified" cash basis. Under that basis of accounting, the financial statements reflect only transactions affecting cash or cash equivalents. The pure cash basis treats all receipts of cash as cash increases and all disbursements of cash as cash decreases. (For example, proceeds from maturing investments and interest are recorded when received and cash purchases of investments are reflected as expenditures, not assets, when paid.) In addition, noncash transactions such as charges against income (versus principal) for depreciation, as allowed by Section 13(a)(2) of the Uniform Principal and Income Act, are not recorded because they do not affect cash or cash equivalents. Although fiduciary accounting uses cash basis recognition principles in many areas (for example, liabilities), the authors believe the pure cash basis of accounting rarely results in fiduciary accounting in accordance with the governing document and/or state law. Accordingly, the authors believe the pure cash basis of accounting usually is not appropriate for trusts and estates.

Considerations for Modified Cash Basis Financial Statements

As discussed in the previous paragraph, both the SSARS and the SASs use the term *cash basis* to describe the pure cash basis of accounting. Because the pure cash basis of accounting is used infrequently in practice, for all entities—not just trusts and estates, many accountants use the term *cash basis* to refer to modifications of the pure cash basis. The *modified cash basis of accounting* is described by AU-C 800.07 and AR-C 60A.07 as the cash basis incorporating modifications that have substantial support.

Accountants may label the basis of accounting for trusts and estates as the modified cash basis of accounting. The authors believe the language in governing documents and state statutes often contemplates the modified cash basis of accounting. For example, although a basis of accounting may not be formally specified, state statutes often use language such as "cash receipts" and "cash disbursements." In an informal poll conducted by the authors, absent language to the contrary in the governing document, most fiduciary accountings are prepared using the modified cash basis of accounting in those states with statutes that have the type of language referred to in the preceding sentence. Such modified cash basis presentations are often considered to be GAAP in the relevant jurisdiction. The authors believe state statutes often constitute substantial support for modifying the cash basis of accounting.

Under that basis, certain transactions are recorded on the accrual basis (i.e., GAAP basis) and other transactions on the cash basis. However, evaluation of these modifications is not clear for fiduciaries because GAAP is not well defined for trusts and estates. Thus, many accountants do not feel comfortable referring to estate or trust financial statements as modified cash basis financial statements. Other accountants present modified cash basis financial statements similarly to commercial entities. For example, they typically record assets at historical cost or fair value

(depending on the type of asset), capitalize property and equipment, and record current and long-term liabilities. The authors believe there is no single answer to the issue of which modifications to the cash basis are appropriate because of the varying interpretations of GAAP for fiduciaries, the diverse report requirements included in governing documents and/or state law, and the varying needs of financial statement users.

As a practical matter, financial statements prepared on the entity's tax basis may provide essentially the same information as cash basis statements modified for the types of transactions discussed in the preceding paragraph. That often occurs because trusts and estates generally use the cash basis of accounting for tax purposes. In those situations, some accountants choose to identify and report on the financial statements as income tax basis financial statements rather than modified cash basis financial statements. Identifying and reporting on the statements as income tax basis financial statements eliminates the need to evaluate the appropriateness of modifications to the pure cash basis. However, the authors believe that accountants should not casually substitute the tax basis for the modified cash or other bases of accounting for fiduciary entities for the following reasons:

- Use of the tax basis would rarely be appropriate for court accountings, unless such basis was specified in the governing document.
- Tax basis presentations may include assets not recognized by the administrable estate.
- The tax basis of certain assets is different than fiduciary acquisition value, which is the basis of assets in fiduciary accountings.

The most common modifications for trusts and estates using the modified cash basis of accounting result from reporting certain liabilities on the accrual basis (e.g., debts of the estate) or capitalizing noncash assets such as property and equipment and mineral interests. However, there are other variations. Also, in many instances, the same accounting records may be identified as modified cash basis by some accountants and GAAP basis by others due to the lack of a clear definition of GAAP for estates and trusts. The following are some of the issues unique to trusts and estates that prepare modified cash basis financial statements:

- *Assets over Which the Fiduciary Has No Management and Control.* The authors believe trusts or estates that modify the pure cash basis to include assets over which the fiduciary has no management or control should record such assets at their *fiduciary acquisition value*, which represents market value on the date assets are transferred to the fiduciary (or cost for assets purchased). Presumably, the intent behind presenting these assets in the financial statements is to provide a more complete accounting to financial statement users about the trust or estate's assets. Accounting conventions that are generally considered GAAP for fiduciaries exclude such assets from any statements prepared.
- *Property, Equipment, and Other Noncash Assets.* Property, equipment, and other noncash assets may be transferred to or purchased by the fiduciary. If the trust or estate decides to record transfers and acquisitions of such assets, the authors believe they should capitalize all such acquisitions in accordance with the governing document and/or state law. Generally, this results in recording the assets at their fiduciary acquisition value. Although recording such assets is a modification of the pure cash basis, it is not a modification from what is generally considered GAAP for trusts and estates.
- *Current and Long-term Liabilities.* If the pure cash basis is modified to recognize liabilities, accountants should consider whether the approach is consistent with the reporting objectives of the presentation. Such modifications should generally be evaluated in terms of whether they comply with an accounting methodology that has substantial support and are logical. However, accounting conventions that are generally considered GAAP for fiduciaries would result in liabilities being recognized on a cash basis (that is, when payment is made).

Considerations for Income Tax Basis Financial Statements

If the filing threshold is met, estates and trusts must file the following tax returns:

a. Form 706 [United States Estate (and Generation-Skipping Transfer) Tax Return] is used to determine and report a decedent's estate tax liability. Federal estate tax is imposed on the transfer of an individual's property at death and certain other transfers considered the equivalent of a transfer at death. The "gross

estate" subject to tax can contain a variety of property interests, including life insurance, jointly owned property, and under certain circumstances, property the decedent gave away before death. Form 706 summarizes the decedent's taxable estate, including the gross estate and allowable deductions (balance sheet only presentation).

b. Form 1041 (U.S. Income Tax Return for Estates and Trusts) is used by the fiduciary of a domestic estate, trust, or bankruptcy estate to report (1) the income received by the estate or trust, (2) whether that income is accumulated and held for future distribution or distributed currently to the beneficiaries, and (3) any applicable tax liability of the fiduciary. IRC Sec. 6012 prescribes the federal income tax return filing requirements for estates and trusts.

An arrangement referred to as a "trust" or an "estate" may not always be treated as such for tax purposes. Conversely, Reg. 1.6012-3(a) generally requires every fiduciary (or at least one of joint fiduciaries) to file Form 1041 (if the income filing threshold is met). Generally, this filing requirement applies when an organization (e.g., a bank) or individual is vested with broad discretionary powers of administration and management and a fiduciary relationship exists.

For estates and trusts electing to use the tax basis of accounting, the authors believe such fiduciary entities should base their tax basis financial statements on the requirements of the form they expect to file. Thus, they believe estates or trusts not required to file a return with the IRS may not prepare income tax basis financial statements because the fiduciary entities do not "use" or "expect to use" the basis of accounting to file a tax return. In that case, use of the tax basis for accounting purposes would not be appropriate. The authors believe income tax basis statements are rarely prepared for estates due to their relatively short duration. Subject to several exceptions, the IRS presumes that an estate's administration has been "unduly prolonged" if the estate remains open more than two years after the decedent's death. As with an estate, the winding up of a trust cannot be unduly prolonged. However, trusts may have a long-term existence before termination. Generally, the determination of whether a trust has terminated for income tax purposes depends upon whether the property held in trust has been distributed to the beneficiaries rather than on technicalities, such as whether the trustee has rendered a final accounting.

The guidance in the following paragraphs applies to situations in which the tax basis of accounting is used to record information that will be reported on Form 706 for estates or Form 1041 for estates or trusts. Note that the federal income tax return of an estate or trust may include assets not recognized by the administrable estate (see the discussion in *PPC's Guide to Accounting and Reporting for Estates and Trusts*), and those not included in accounting records prepared in accordance with the previously mentioned basis of accounting alternatives.

Accounting Methods. The fiduciary of a trust or estate may choose the accounting methods to be used by the entity in its Form 1041 reporting, regardless of the methods used by the grantor or decedent. That allows the fiduciary to terminate an undesirable method used by the decedent or grantor. However, the accounting methods selected by the fiduciary must be used consistently and must clearly reflect income. Accounting methods include not only the overall method, such as cash or accrual, but also the special methods used to determine the tax treatment of specific items.

Similar to individuals, most fiduciaries use the cash basis method of accounting. However, similar to commercial business entities, the accrual method is required when the production, purchase, or sale of merchandise is a material income-producing factor, regardless of whether inventory is physically on hand at year-end. The accrual method would be required, for example, when an estate continues to operate an accrual-basis manufacturing proprietorship owned by the decedent. That may result in using a hybrid overall accounting method if the accrual method is used for purchases and sales, and the cash method is used for other items of income and expense.

Form 1041 Considerations. Fiduciary accounting income, although not a tax concept, is nevertheless required to be disclosed by trusts (but not estates) on Form 1041. Estates are only required to show taxable income on Form 1041; however, the fiduciary must determine fiduciary accounting income for distribution purposes, and such distributions are reflected on the tax return. Although fiduciary accounting income must be determined in accordance with the governing document and/or state law, the tax law must be complied with regardless of the provisions of the governing document or state law. Tax considerations for estates and trusts are essentially the same as that of an individual with a few exceptions. Major exceptions include the following:

- *Personal Exemption.* The personal exemption deductible for estates, simple trusts, and complex trusts are $600, $300, and $100, respectively. In contrast, the personal exemption for individuals is suspended for the years 2018–2025 (by the TCJA).
- *Charitable Contributions.* Deductions for charitable contributions are unlimited at the trust and estate level.

The income of an estate or trust is taxed to the estate or trust itself, to its beneficiaries, or in part to each. Generally, beneficiaries are taxed only on the distributions received or distributable. In addition, the estate or trust receives a special deduction for amounts taxable to but not actually distributed to the beneficiary.

As discussed earlier in this section, tax basis statements may be substantially identical to modified cash basis financial statements. This often occurs because trusts and estates generally use the cash method of accounting. However, the authors believe that practitioners must carefully evaluate the reasons for using the tax basis of accounting instead of the modified cash basis for fiduciary entities.

Accounting Considerations for Estates. The estate's basis in property acquired from a decedent is generally the fair market value of the property on the decedent's date of death (or, if the total value of the estate has declined, the alternate valuation date), as discussed below. However, for the estates of decedents who died in 2010, executors could have elected to use the modified carryover basis rules instead of the stepped-up basis rules. The modified carryover basis rules are discussed later in this section.

Basis Considerations—Fair Market Value (Stepped-up) Basis Rules. Assets included in an estate generally receive a step-up in basis. That is, they are valued at fair market value (FMV) on the decedent's date of death (or alternate valuation date) rather than at the decedent's tax basis. However, property representing income in respect of the decedent (IRD) is not "stepped up" to fair market value. [*Income in respect of a decedent* (IRD) is income to which the decedent was entitled but due to his death was not includible in his taxable income. An example of IRD is salary earned but not paid to a cash basis taxpayer. Although the taxpayer had earned the salary, since it was not paid until after his death, it could not be included on his final income tax return. Because the income was never subject to income tax, someone must pay income taxes on it when received. Note that no step-up in basis exists for IRD at death.] After initial recording, the estate's assets, liabilities, income, and expenses generally are measured by following (a) fiduciary accounting principles for allocating receipts and disbursements to principal and income, and (b) tax conventions for individuals, with some exceptions. The following provides additional guidance for determining the value of an estate's assets and liabilities on the date the estate is created:

a. *Real Estate.* Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having knowledge of relevant facts. In the case of real estate, the FMV is determined based on the property's highest and best use, not its actual use. Therefore, if closely held business real property, such as farm property, included in the decedent's estate has a greater value for residential or industrial purposes than it does as actually used, the value of the property for estate tax purposes will be based on its higher and better use. However, if certain detailed requirements are met, the executor can elect to value qualified real property included in a decedent's gross estate that is used for farming or other trade or business purposes based on its current use, rather than its FMV based on its highest and best use. (The election is referred to as the *special use valuation election* and can serve to reduce the estate's tax liability.)

   If the real property is sold during the estate's administration and the date of sale is shortly after the valuation date, the realized sales price will ordinarily be considered more indicative of value than any of the appraised valuations. However, if the executor can document that there has been a major change in the market after the valuation date and before the date of sale, resulting in a higher sales price than the appraised valuation, the IRS may agree that the appraised valuation was correct.

   Generally, there are three recognized methods for valuing real property—the cost method, the income capitalization method, and the comparable sales method. Each of these methods is discussed in *PPC's 706/709 Deskbook.*

b. *Oil and Gas Properties.* When valuing mines, oil and gas wells, and other natural deposits, the IRS regulations consider all factors relevant to the market value such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, valuation for local and state

taxation purposes, partnership accountings, litigation records, probate court appraisals, and disinterested party appraisals by an approved method. In addition, the FMV of mineral properties and improvements valued on a specific date (e.g., date of death), must be determined in light of the conditions and circumstances known on that date, regardless of later discoveries or developments or later improvements in methods of extraction and treatment of the mineral products. The courts also consider many other factors when determining the value of an oil and gas interest including reserves bypassed when drilling the hole, reserves that may be below the present producing sands, salvage rights to the equipment upon abandonment of the well, and whether the owner of the interest can be the operator of the working interest.

Common methods for determining the value of an oil and gas interest include computing the present value of the projected income stream or other analytical appraisal methods. The regulations state that the present value methods cannot be used, however, if mineral property and improvements can be valued on the basis of cost or comparative values and replacement value of equipment, or when the FMV can be determined by any method other than an analytical method.

c. *Investments.* When the value of stocks is listed on an exchange, the valuation process consists of locating the security's value in a financial publication. However, when securities are not traded on an open market (e.g., closely held stock), the services of a professional appraiser may be required to establish the security's value. In either event, a valuation discount or premium may be appropriate if the decedent held a minority interest or controlling interest, or the securities were subject to restrictions.

d. *Cash.* The FMV of cash in the decedent's possession (including cash found in a safety deposit box or deposited in a bank) is its face value. Collectible coins and currency with a value in excess of face value (e.g., gold or silver coins) are reported at their higher value. Foreign currency is valued in U.S. dollars, based on the official exchange rate on the valuation date.

e. *Certificates of Deposit.* Certificates of deposit (CDs) are included at the principal amount of the CD plus unpaid interest. No discount is allowed for early withdrawal penalties because they are not imposed for early withdrawals resulting from the death of the owner.

f. *Checking Accounts.* Checking accounts may be reported on the income tax basis using either the gross or the net method. Under the gross method, the balance in the checking account on the decedent's date of death is reported before any adjustments for outstanding checks. Outstanding checks that represent obligations of the decedent are recorded separately and are deductible on Form 706 (see item h). The net method reports the balance of the checking account adjusted for outstanding checks issued for bona fide obligations of the decedent.

Decedents (or their agents acting under a power of attorney) sometimes write checks to family members near the time of death (referred to as *death bed gifts*) that are intended to qualify for the annual per donee gift tax exclusion. It is common for some or all of these checks to remain uncashed at death. The criteria for classifying outstanding gift checks as completed gifts (and thus excluding the amounts from the gross estate) is different for noncharitable gifts and charitable gifts. In either situation, gifts made under a power of attorney will not be considered valid unless the power specifically authorizes them. For noncharitable gifts, generally, unless the check has cleared the decedent's account as of the date of death, it is not a completed gift and therefore cannot be excluded from the decedent's gross estate. Checks written to charitable organizations before death, but not clearing the bank until after death, are usually deductible on the decedent's final income tax return and not includable in the gross estate.

g. *Life Insurance.* Proceeds of life insurance on the decedent's life are included in the gross estate if they are receivable by the estate (that is, the insured's estate is the named beneficiary of the policy) or by another for the benefit of the estate. Proceeds not receivable by or for the benefit of the estate may also be included if the decedent possessed incidents of ownership in the policy (that is, the insured or the insured's estate has a right to the economic benefits of the policy).

h. *Liabilities.* When preparing the Form 706, estates are permitted to record (deduct) claims representing personal obligations of the decedent that existed and were legally enforceable at the time of death, whether matured or unmatured. This includes unsecured notes, claims for services provided, and contracts for the

purchase of property. In addition unpaid taxes and mortgages and other debts on property may be recorded (deducted).

Alternate Valuation Date—Fair Market Value (Stepped-up) Basis Rules. As mentioned above, when the total value of the estate has declined, an executor can choose to value the decedent's assets on either the date of death or the alternate valuation date, which is six months after the date of death [IRC Sec. 2032(a)]. However, if property is sold, exchanged, distributed, or disposed of between the date of death and six months after death, the date of disposal becomes the alternate valuation date.

The primary benefit of electing the alternate valuation date is the estate (and possibly generation-skipping transfer) tax savings that result from lowering the overall value of the property included in the estate when the total value of the estate assets has declined between the date of death and six months later. However, this election can only be made if it decreases both (a) the value of the decedent's gross estate and (b) the amount of federal estate tax after reductions for all allowable credits. While it is possible to elect to use the alternate valuation date when some assets have decreased in value and others have increased, there must be a net decrease in order to make the election.

Before the election is made, several issues should be considered to determine how they affect the benefits gained from making the election. An important consideration is the potential conflict among the estate's beneficiaries. Most property received from a decedent receives a basis equal to its FMV at the date of death. However, if the alternate valuation date is elected, the property's basis equals its value on this latter date. Typically, the election causes a net tax savings because the marginal estate tax bracket usually is greater than the estate's or beneficiary's income tax bracket. In some situations, however, the estate tax savings achieved for the lower estate tax basis might be offset by an increased income tax liability when the inherited property is sold by the beneficiary. This is particularly true if the beneficiary is contemplating selling the property relatively soon after receiving it.

Typically, if the overall value of the estate drops between the date of death and the alternate valuation date, some of the estate's assets will have increased in value while others will have decreased. In addition, some of the estate's assets will probably be sold quickly, while others may never be sold or are not likely to be sold until after passing through another estate (e.g., at the death of a surviving spouse) and receiving a step-up in basis. Thus, the decision to make the alternative valuation election normally requires more than simply calculating the total estate tax savings and income tax costs for the estate and beneficiaries. The election's effect on each major asset or group of assets generally should be considered separately. Additional information on the alternative valuation date is provided in *PPC's 706/709 Deskbook*.

Basis Considerations—Modified Carryover Basis Rules (2010 Tax Relief Act). Under the modified carryover basis rules, the estate's basis in assets received from a decedent is generally the FMV of the property on the decedent's date of death (or alternate valuation date). However, executors of estates of decedents who died in 2010 could have elected out of the estate tax, thus replacing the step-up in basis with modified carryover basis provisions. (The election must have been made on or before January 17, 2012.) Under these provisions, property transferred at the decedent's death generally would have received a basis equal to the lesser of the decedent's adjusted basis (with certain modifications) or the property's FMV on the date of the decedent's death (i.e., no step-up). However, a decedent's estate generally was permitted to increase the basis of appreciated assets owned by and acquired from the decedent (but not above FMV at the date of death) by up to a total of $1.3 million. The $1.3 million could have been increased by the amount of unused capital losses, net operating losses (NOLs), and various other built-in losses of the decedent. In addition, the basis of appreciated property transferred to a surviving spouse could have been increased by an additional $3 million. No basis increase was allowed for property that is considered income in respect of a decedent (IRD).

PPC's Tax Planning and Advisory Estate and Wealth Transfer Planning topic and *PPC's 706/709 Deskbook* provide further information on estate tax rules and the modified carryover basis rules.

Accounting Considerations for Trusts. In general, trusts only pay tax on income it accumulates. When distributions of income are made to beneficiaries, the trust is treated as a conduit for income tax purposes. Instead of paying tax on distributed income, the income and deductions are taxed to the beneficiaries to the extent they receive (or are entitled to receive) income from the trust. Unlike estates that follow the traditional step up in basis rules, assets transferred during a donor's lifetime to a trust do not receive a step-up in basis. Instead, they generally are recorded

at the donor's tax basis. Consequently, measurement issues for a trust's tax basis financial statements are similar to those for individuals. Determining the tax basis of assets depends on—

- the type of trust.
- how the property was acquired (e.g., transfers during life, after death through a will, by gift, or other means).
- the nature of the asset.

PPC's Tax Planning and Advisory Estate and Wealth Transfer Planning topic and *PPC's 1041 Deskbook* include a comprehensive discussion of trust (and estate) taxation issues.

Disclosure Considerations

AU-C 700 requires an evaluation of whether the audited financial statements achieve fair presentation (AU-C 700.12–.17). AU-C 800 provides guidance on what constitutes fair presentation for special purpose financial statements, as summarized below:

- AU-C 800.16 states that special purpose financial statements should include, among other things, a summary of significant accounting policies that discusses the financial reporting framework used to prepare the financial statements and describes how the framework differs from GAAP. (The effects of these differences need not be quantified.) In addition, only significant differences need to be described. (If financial statements are prepared in accordance with a contractual basis of accounting, AU-C 800.17 states that the financial statements also should adequately describe any significant interpretations of the contract on which the financial statements are based.) The authors believe the disclosure only needs to address the substance of the differences between the bases; thus, a detailed discussion of the GAAP treatment of an item is unnecessary. Normally, trusts and estates present the disclosure of the basis of accounting at the beginning of the summary of significant accounting policies under a heading such as "Basis of Accounting."
- When special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, AU-C 800.18 states that informative disclosures similar to those required by GAAP are necessary to achieve fair presentation.
- AU-C 800.18 also states that additional disclosures, beyond those specifically required by the basis of accounting used to prepare the special purpose financial statements and related to matters not specifically identified on the face of those statements, might also be necessary for special purpose financial statements to achieve fair presentation.

Similar requirements are included in the SSARS for compiled (AR-C 80A.18) or reviewed (AR-C 90A.77) financial statements.

Because disclosures in special purpose financial statements should contain informative disclosures similar to those in GAAP presentations, the following discussion summarizes some of the GAAP disclosure requirements for trusts and estates. Although the SSARS allow the client to omit substantially all disclosures in a preparation engagement or a compilation engagement, the authors do not encourage that reporting alternative because the accounting conventions for estates or trusts are not widely known by the public. Also, certain GAAP accounting conventions can be peculiar to each entity, depending on the requirements of the governing document. Whenever possible, accountants should recommend that the financial statements include the following note disclosures:

a. The financial reporting framework (that is, the basis of accounting) and how it differs from GAAP.
b. A summary of significant accounting principles that explains the special purpose framework's accounting conventions used and any peculiar accounting required by the governing document (or state law). (Also required by the auditing and SSARS guidance.)
c. A disclosure of significant transactions that do not affect the amount (or assets) for which the fiduciary is accountable. For example, the authors encourage disclosure in a note (or parenthetically on the face of the

statement) of any debt that is secured by a deed of trust on assets of the estate or trust. (Such disclosure is encouraged by the Committee on National Fiduciary Accounting Standards.)

d. A description of the methods used to determine current values.

e. A disclosure of major subsequent events and the date through which subsequent events are evaluated. For example, a major decline in the current values of an asset (like common stock) that occurred between the financial statement date and the date that the report is issued should be disclosed.

Considerations When Preparing Estate or Trust Financial Statements

If the accountant is hired by a fiduciary to perform accounting services that result in financial statements, in the authors' opinion, the provisions of SSARS should apply (absent a contrary reporting requirement of a court of law). In such an engagement, most accountants would agree that the accountant is practicing public accounting but is not acting as an employee or member of management. In that instance, the type of SSARS engagement would depend on the service for which the accountant was engaged. If the CPA who is practicing public accounting acts as executor or trustee and prepares financial statements, the authors believe that the provisions of the SSARS do not apply and the accountant could, instead, choose to provide a statement communicating his or her relationship with the estate or trust to accompany the financial statements. *PPC's Guide to Accounting and Reporting for Estates and Trusts* provides a detailed discussion of the accountant's reporting requirements for the financial statements of estates and trusts.

SELF-STUDY QUIZ

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

16. Determining how to account for an estate or trust normally is dependent upon or subject to proper interpretation of which of the following?

    a. FASB pronouncements and guidance.

    b. AICPA nonauthoritative literature.

    c. GAAP for fiduciary accounting.

    d. State law and the will or trust agreement.

17. According to the text, which special purpose framework would be **least** appropriate for the fiduciary financial statements of an estate or trust?

    a. The pure cash basis of accounting.

    b. The modified cash basis of accounting.

    c. The income tax basis of accounting.

    d. The fiduciary acquisition value.

18. The Habersham Estate included the following assets. Which one has been reported at the correct value?

    a. Certificates of deposit are reduced for relevant early withdrawal penalties.

    b. Foreign currency is valued in the currency of the country of origin.

    c. The decedent's home is recorded at the fair market value of its highest and best use.

    d. Income in respect of the decedent is stepped up to fair value at the date of death.

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.)**

16. Determining how to account for an estate or trust normally is dependent upon or subject to proper interpretation of which of the following? **(Page 172)**

    a. FASB pronouncements and guidance. [This answer is incorrect. An authoritative body such as the FASB has not issued a pronouncement (or other guidance) dealing with fiduciary accounting.]

    b. AICPA nonauthoritative literature. [This answer is incorrect. Nonauthoritative literature issued by the AICPA does not directly address fiduciary accounting.]

    c. GAAP for fiduciary accounting. [This answer is incorrect. The determination of GAAP for fiduciary accounting is difficult. The presentation, disclosure, and reporting issues for estates and trusts are uniquely different from those for a typical corporate entity. Unfortunately, little authoritative guidance exists on the subject of estate and trust financial statements.]

    d. **State law and the will or trust agreement. [This answer is correct. The determination of how to account for an estate or trust normally depends upon, or is subject to, the proper interpretation of a governing document (the will or trust agreement) and the laws of the state having jurisdiction.]**

17. According to the text, which special purpose framework would be **least** appropriate for the fiduciary financial statements of an estate or trust? **(Page 178)**

    a. **The pure cash basis of accounting. [This answer is correct. Although fiduciary accounting uses cash basis recognition principles in many areas, the authors believe the pure cash basis of accounting rarely results in fiduciary accounting in accordance with the governing document and/or state law. Accordingly, the authors believe the pure cash basis of accounting usually is not appropriate for trusts and estates.]**

    b. The modified cash basis of accounting. [This answer is incorrect. Accountants may label the basis of accounting for trusts and estates as the modified cash basis of accounting. The authors believe the language in governing documents and state statutes often contemplates the modified cash basis of accounting. As long as the incorporated modifications have substantial support, then this basis of accounting may be appropriate for estates and trusts. Thus, there is a better answer to this question.]

    c. The income tax basis of accounting. [This answer is incorrect. For estates and trusts electing to use the tax basis of accounting, the authors believe such fiduciary entities should base their tax basis financial statements on the requirements of the form they expect to file. Thus, they believe estates or trusts not required to file a return with the IRS may not prepare income tax basis financial statements because the fiduciary entities do not "use" or "expect to use" the basis of accounting to file a tax return. In that case, the use of the tax basis for accounting purposes would not be appropriate. However, though it might rarely be used for estates, this basis of accounting can be appropriate for certain types of fiduciary financial statements. Therefore, there is a better answer to this question.]

    d. The fiduciary acquisition value. [This answer is incorrect. The authors believe trusts or estates that modify the pure cash basis to include assets over which the fiduciary has no management or control should record such assets at their *fiduciary acquisition value*, which represents market value on the date assets are transferred to the fiduciary (or cost for assets purchased). However, it is not a special purpose framework.]

18. The Habersham Estate included the following assets. Which one has been reported at the correct value? **(Page 181)**

    a. Certificates of deposit are reduced for relevant early withdrawal penalties. [This answer is incorrect. Certificates of deposit (CDs) are included at the principal amount of the CD plus unpaid interest. No discount is allowed for early withdrawal penalties because they are not imposed for early withdrawals resulting from the death of the owner.]

    b. Foreign currency is valued in the currency of the country of origin. [This answer is incorrect. Foreign currency is valued in U.S. dollars, based on the official exchange rate on the valuation date. Therefore, valuing the currency based on the value of the currency of the originating country would not be the correct valuation.]

    c. **The decedent's home is recorded at the fair market value of its highest and best use. [This answer is correct. Fair market value for real estate is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having knowledge of relevant facts. In the case of real estate, the fair market value is determined based on the property's highest and best use, not its actual use.]**

    d. Income in respect of the decedent is stepped up to fair value at the date of death. [This answer is incorrect. Assets included in an estate generally receive a step-up in basis. That is, they are valued at fair market value on the decedent's date of death (or alternate valuation date) rather than at the decedent's tax basis. However, property representing income in respect of the decedent (IRD) is not "stepped up" to fair market value.]

WORKING WITH PERSONAL FINANCIAL STATEMENTS

FASB ASC 274 is the principal authoritative literature providing measurement and disclosure guidance for personal financial statements, including the form of the financial statements. It establishes the estimated current value basis of accounting as GAAP for personal financial statements.

Accountants are frequently asked to prepare, compile, review, or audit personal financial statements for use in obtaining credit; for estate, retirement, or other planning purposes; or for public disclosure by candidates for public office. The authors believe that personal financial statements most commonly use the current value basis of accounting (GAAP). However, the use of other bases also occurs and the AICPA Guide, *Preparation, Compilation, and Review Engagements* (AICPA Guide), Chapter 5, recognizes that personal financial statements might be presented on a basis of accounting other than GAAP, indicating that accountants may prepare, compile, or review personal financial statements that are prepared in accordance with a special purpose framework. The AICPA Guide, Paragraph 5.05, also indicates that for purposes of personal financial statements, examples of special purpose frameworks include historical cost, tax, and cash.

General Considerations

Definition. The term *personal financial statements* refers to financial statements that present the personal assets and liabilities of an individual or group of related individuals. Thus, personal financial statements may be prepared for—

a. An individual.

b. A married couple.

c. A larger family group.

Personal financial statements do not include financial statements that present the financial position or results of operations of unincorporated business enterprises such as proprietorships or partnerships.

Ownership Information. Typically, personal financial statements present the combined assets and liabilities of a married couple and sometimes their dependent children. When such combined statements are presented, it may be useful to disclose each individual's interest in the net assets shown in the combined statements in an additional statement or in a note to the financial statements.

When personal financial statements are prepared for only one of a group of joint owners of assets (or when additional statements are prepared for each individual owner), only the share that the individual has a right to as a beneficial owner under the property laws of the state should be included as part of the individual's assets.

When property is held in joint tenancy or as community property, the legal status of the separate equities of the parties may not be clear. Thus, the advice of an attorney may be required to determine whether the property interest should be included in the financial statements and, if so, the proper allocation under the applicable state laws. When such property is included in the combined personal financial statements of a married couple or other family group, full disclosure of the circumstances is generally necessary.

Basis of Presentation. FASB ASC 274-10-35-1 establishes the estimated current value basis of accounting as GAAP for personal financial statements. Under that basis of accounting, assets are presented at their estimated current values and liabilities are presented at their estimated current amounts. FASB ASC 274-10-25-1 also states that assets and liabilities should be recognized on the accrual basis, not on the cash basis.

Personal financial statements may be prepared on an accounting basis that satisfies the definition of a special purpose framework found in AU-C 800 and the SSARS. Such special purpose framework statements may result in personal financial statements that are prepared on one of the following bases:

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

b. *Modified Cash Basis.* Under the modified cash basis, the pure cash basis is modified to report certain assets and liabilities, generally at the amounts that would be reported under either the historical cost basis or the current value basis.

c. *Tax Basis.* Assets and liabilities under the tax basis are measured in accordance with the principles the individual uses for federal or other income tax reporting.

d. *Historical Cost Basis.* The historical cost basis generally measures the individual's assets and liabilities based on the assets' and liabilities' original cost. In certain circumstances, adjustments to historical cost may be necessary, as discussed in various places within this section.

The Basic Financial Statements. FASB ASC 274-10-45-4 discusses two basic personal financial statements—the statement of financial condition and the statement of changes in net worth. The basic objective of the statement of financial condition is to present at a point in time an individual's assets and liabilities at their current value, with the difference between assets and liabilities shown as net worth. It is a balance sheet type of presentation. Classifying assets and liabilities as current and noncurrent is not appropriate because an individual's financial affairs do not usually involve an operating cycle. Thus, FASB ASC 274-10-45-7 recommends that assets and liabilities be shown in order of liquidity and maturity. When a special purpose framework is used, the authors believe the design of the statement should be the same, but it should not use terms that are normally associated with current value presentations, such as *financial condition* and *net worth*. For example, *assets and liabilities* and *net assets* could be used in place of those terms.

The personal affairs of individuals do not constitute a business enterprise. Therefore, a statement presenting results of operations is *not* a basic personal financial statement. Instead, the statement of changes in net worth presents the major sources of increases and decreases in the individual's net worth for a period of time. It normally discloses income sources, major components of expenditures, and other sources of major changes in assets or liabilities.

The statement of changes in net worth does not attempt to present net income and is not required for a fair presentation of financial condition. The presentation of a statement of changes in net worth is *optional* according to FASB ASC 274-10-45-4. In practice, the statement is infrequently presented because creditors do not normally consider it necessary. When a special purpose framework is used, the authors believe the financial statement should not use titles and terms customarily associated with current value presentations. For example, the statement title could refer to changes in *net assets* or *equity*, depending on the caption used in the statement of assets and liabilities.

Inadequate Accounting Records. Individuals generally do not maintain formal financial or accounting records. As a result, all assets and liabilities are often not recorded. Before compiling or reviewing personal financial statements, the accountant needs to consider whether it is necessary to perform additional accounting services. Generally, such services will consist of gathering necessary information by inquiry of the client and review of available financial records. *PPC's Guide to Compilation and Review Engagements* provides guidance on performing additional accounting services related to personal financial statements.

Types of Engagements Performed for Personal Financial Statements. Standards for compilation of financial statements prescribed by AR-C 80A are applicable to the compilation of personal financial statements in the same manner as to the compilation of other financial statements. For example, the requirement in AR-C 80A.12 to obtain an understanding of the applicable financial reporting framework and the significant accounting policies to be used to prepare the financial statements would be considered to be a requirement that the accountant should have knowledge of those items applicable to personal financial statements.

Similarly, the SSARS are applicable to the review of personal financial statements in the same manner as the review of other financial statements. Accordingly, to review personal financial statements, the accountant must meet the performance requirements of AR-C 90A. In general, the accountant should possess (a) a level of knowledge of the accounting principles and practices applicable to personal financial statements and (b) an understanding of the individual's financial activities and financial position that will provide the accountant, through the performance of inquiry and analytical procedures, with a reasonable basis for expressing limited assurance that no material modifications are necessary to the financial statements for them to conform to the applicable financial reporting

framework. Knowledge of the accounting principles and practices applicable to the personal financial statements implies that the accountant is thoroughly familiar with the requirements of FASB ASC 274.

Additionally, the accountant may also be engaged to prepare (under AR-C 70A) or audit personal financial plans based on the needs of the financial statement users.

Considerations for Pure Cash Basis Financial Statements

In AU-C 800.07 and AR-C 60A.07, the "cash basis of accounting" refers to a "pure" or "unmodified" cash basis. Under that basis of accounting, transactions are recorded only when cash is collected or paid. Its use results in measuring only one asset: cash; and no liabilities. For example, salaries are recorded when received, and cash purchases of automobiles are reflected as expenditures, not assets, when paid. In addition, noncash transactions such as property acquired by inheritance are not recorded since they do not affect cash.

Personal financial statements are sometimes prepared on the pure cash basis of accounting, for example, in connection with divorce proceedings or bank loans.

Considerations for Modified Cash Basis Financial Statements

Under the modified cash basis, the pure cash basis is modified to report certain assets and liabilities other than cash. For example, property and equipment is usually capitalized in modified cash basis financial statements and long-term liabilities are usually recorded.

How Should the Modifications Be Measured? The most significant question when preparing personal financial statements on the modified cash basis is determining how the modifications should be measured. Accountants disagree as to whether they should be measured using historical cost basis principles or the estimated current value measurement principles that would be required by FASB ASC 274-10-35 for a GAAP presentation.

Many accountants believe that modified cash basis personal financial statements can present assets and liabilities based on cash (or modified cash) basis recognition principles and estimated current-value measurement principles. Those accountants feel that cash basis recognition principles for determining which assets and liabilities to include in personal financial statements can be applied in conjunction with estimated current-value measurement principles. Other accountants believe that AU-C 800 considers modifications of the cash basis only with regard to historical cost measurement principles. Those accountants also believe that applying estimated current-value principles generally produces the same values regardless of which recognition principle is used.

Because AU-C 800.07 and AR-C 60A.07 require that modifications should have substantial support, the authors believe that modifications can be measured using either the historical cost basis or the current value basis. As a practical matter, when part of the cost of an asset is financed, the authors believe the amount recorded would include the amount financed as well as the down payment. For example, modifying the cash basis to report the individual's personal residence reports misleading results if the residence is reported only at the total of cash payments made to the date of the financial statements. Similarly, a modification to report the individual's investment in marketable equity securities would also involve reporting the balance due under margin accounts.

Generally, the difference between measuring modifications at their historical cost or current value basis relates to whether unrealized appreciation or depreciation subsequent to when the asset was acquired or the liability was incurred is recognized. For example, if the cash basis is modified to report the individual's investments in available-for-sale debt securities, the modifications would be reported as follows using the historical cost basis or the current value basis:

a. *Historical Cost Basis.* Using the historical cost basis, the investment would initially be reported at its cost, including the amount financed through margin accounts. Subsequent adjustments would be recognized for amortization of premiums and discounts and for declines in fair value below amortized cost that are other than temporary.

b. *Current Value Basis.* Under the current value basis, the securities would be adjusted to their fair value and the obligation under margin accounts would generally be reported at the amount of principal outstanding.

The authors believe that modifications to the pure cash basis should not be so extensive that the financial statements no longer reflect a cash orientation. Modifications to report amounts due under royalty agreements, vested retirement plan interests, and obligations under divorce agreements are examples of modifications that are not consistent with a cash orientation. As a practical matter, the modified cash basis of accounting used for income tax reporting often meets the needs of individuals who want a presentation of financial results showing a cash orientation. The types of modifications and their measurement would be the same as the individual uses for income tax reporting.

Considerations for Historical Cost Basis Financial Statements

As previously discussed, the AICPA Guide includes the historical cost basis as a special purpose framework for personal financial statements. Under the historical cost basis of accounting, assets and liabilities are recorded at original cost. While the historical cost basis of accounting is not GAAP, generally accepted accounting principles incorporate the concept of historical cost, and thus, the authors believe the measurement and disclosure principles that are required for the financial statements of entities other than individuals may be applicable to personal financial statements of individuals that are prepared on the historical cost basis.

Assets Acquired by Conventional Purchase. Assets acquired by conventional purchase (i.e., acquired by using cash or by incurring a related debt such as a mortgage payable) should be recorded in historical cash basis personal financial statements at their original cost. For example, securities and personal effects, such as objects of art, jewelry, antiques, fur, and household furnishings, should be recorded at their historical cost basis if they are material.

Assets Acquired Other Than by Conventional Purchase. Personal financial statements often include assets acquired other than by conventional purchase. The authors believe that assets acquired by inheritance and gift should be accounted for as follows in historical cost basis financial statements:

- *Property Acquired by Inheritance.* Cost is fair value at the date of inheritance. That generally is the value used in the final determination of the federal estate tax or state inheritance tax. Note that when community property goes through probate and is distributed to the surviving spouse, only the half of the community property that was inherited is revalued at the date of inheritance. The half interest owned by the surviving spouse before probate continues to carry its previous cost basis.

- *Property Acquired by Gift.* Cost is the fair value of the property at the time of the gift.

Cash. Cash balances should include cash in all bank accounts, including individual checking or savings accounts. It may also include cash balances in a brokerage account. Alternatively, brokerage account cash balances could be included as a separate item after cash.

Life Insurance Policies. Life insurance policies and annuity contracts should be recorded at their cash surrender value, less any loans outstanding. Increases in cash surrender value and in the value of annuities are not significant to most presentations for individuals.

Loans Receivable. Loans receivable are typically due from related parties or buyers of real estate and other investments. They are usually supported by note agreements. The disclosures for loans receivable required by FASB ASC 310-10-50 should be made, or information that communicates the substance of those requirements should be provided.

Material Business Interests. Business interests (including proprietorships, joint ventures, S corporations, C corporations, and partnerships) that constitute a large part of the individual's total assets should be shown separately from other investments. Each investment in a separate entity should be included as one amount in the statement of assets and liabilities. The assets and liabilities of the separate entity should *not* be combined with personal assets and liabilities.

If the individual either controls the investee or has the ability to exercise significant influence over its operating and financial policies, the investment should be presented in the financial statements at cost adjusted for any accumulated undistributed earnings or losses since acquisition. Otherwise, the investment should be reported at its cost.

However, as discussed later in this section, under either scenario, the investment should be reduced for declines in fair value below the basis that are other than temporary.

Real Estate. Common investments in real estate include rental property, personal residences, vacation homes, and property held for speculation. Provision should be made for depreciation of income-producing property, such as rental property. For nonincome producing property, e.g., a personal residence, the carrying basis should be original cost plus the cost of improvements unless there is evidence of a permanent decline in value. See further guidance later in this section for writing assets down if current value is less than historical cost.

Future Interests. Future interests are nonforfeitable rights to receive future sums. FASB ASC 274-10-35-11 requires the estimated current value of a future interest to be included in GAAP basis personal financial statements only if it has all of the following characteristics:

a. The right is for a fixed or determinable amount.

b. The right is not contingent on the holder's life expectancy or the occurrence of a particular event, such as disability or death.

c. The right does not require future performance of service by the holder.

Normally, a transaction or event must occur in order for these three characteristics to exist. Therefore, these are generally the same as the criteria for recognition of future interests by reporting entities other than individuals and are applicable to historical cost basis presentations for individuals. Examples of future interests that frequently have all of those characteristics include guaranteed minimum portions of pensions, vested interests in pension or profit sharing plans, deferred compensation contracts, beneficial interests in irrevocable trusts, remainder interests in property subject to life estates, annuities, and fixed amounts of alimony for a definite period.

Social Security Benefits. According to nonauthoritative AICPA Technical Q&A 1600.03, social security benefits to be received based on the future life expectancy of an individual should not qualify as an asset in personal financial statements. Both FASB ASC 274-10-35-11, which addresses future interests, and Q&A 1600.03 state that the right to future income, which is contingent on the holder's life expectancy or the occurrence of a particular event, do not qualify as a recognizable asset for the personal financial statements. The situation discussed in the previous paragraph describes when the income is being received currently and the life expectancy is used to determine the value of the income stream. This is analogous to when an individual is drawing social security and the right to the income is no longer contingent on the holder's life expectancy and requires no future performance on the individual's part. Instead, the life expectancy is used only to determine the amount of the value of the future income stream. However, if the individual is not yet receiving social security payments, the amount would not be included in personal financial statements. In that situation, the amount is unable to be determined as the amount would vary depending upon which retirement age the individual chose, rights to social security are contingent on the individual reaching a specific retirement age, and social security may require future performance if the individual has not yet earned retirement benefits.

Income Taxes Payable. Unlike partnerships, S corporations, and proprietorships, individuals are taxpaying entities. Historical cost basis personal financial statements should include the following amounts for income taxes:

- *Current Income Taxes Payable.* The liability for current income taxes should include unpaid income taxes for completed tax years. If interim financial statements are prepared, the liability for current income taxes should also include an estimated amount for income taxes accrued for the elapsed portion of the current tax year to the date of the financial statements. That estimate should be based on the relationship of taxable income earned to date to total estimated taxable income for the year, net of the taxes withheld or paid as quarterly estimated tax payments. Current income taxes payable should include state and local, as well as federal, income taxes.

- *Deferred Income Taxes.* Deferred income taxes on the difference between the historical cost and the tax basis of assets should be accrued in the historical cost basis financial statements. For example, an individual may record the historical cost of an investment in oil and gas properties as the original cost, including capitalized intangible development cost (IDC) adjusted for depletion. However, on the individual's income tax return, usually the individual has elected to deduct all IDC when incurred, not over the

depletable life of the property. Accordingly, deferred taxes on the difference between the tax and historical cost basis of the properties would be calculated and recorded in the historical cost basis personal financial statements.

In addition to current income taxes payable, FASB ASC 274-10-35-15 also requires GAAP personal financial statements to include a provision for estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities over their tax bases. Historical cost basis financial statements do not reflect assets and liabilities at estimated current values and, accordingly, would not reflect such an income tax provision.

Noncancelable Commitments. The estimated current amount of a noncancelable commitment should be included in personal financial statements only if it has all of the following characteristics:

a. The commitment is for a fixed or determinable amount.

b. The commitment is not contingent on others' life expectancies or the occurrence of a particular event, such as disability or death.

c. The commitment does not require future performance by others.

Commitments that frequently have all of these characteristics include fixed amounts of alimony for a definite future period and charitable pledges.

Other Liabilities. Accounts payable and accrued liabilities in historical cost basis financial statements include balances on credit cards, utilities, property taxes, insurance, etc. Notes payable in personal financial statements are typically for automobile loans, student loans, or boat loans or for the acquisition of real estate, such as a mortgage payable on a personal residence.

What If Current Value Is Less Than Historical Cost? A common question when preparing historical cost basis financial statements is what to do when the historical cost basis of certain assets is higher than the estimated current values of the same assets. For example, historical cost may be higher than estimated current values for marketable securities, automobiles, or other assets that have suffered depreciation in value.

The authors believe a loss for a decline in fair value below amortized cost should be recognized if GAAP for other reporting entities would require it. For example, such losses should be recognized for declines in—

a. the net realizable value of loans receivable below the amount of principal outstanding.

b. the fair value of investments in securities accounted for at their cost or the individual's equity in the underlying assets of the investee if the decline is other than temporary.

c. the realizable value of long-lived assets such as a home with an amortized cost greater than the current market value of the property, which may occur when property values are declining.

Considerations for Income Tax Basis Financial Statements

AU-C 800.07 and AR-C 60A.07 describe the income tax basis as the basis of accounting an entity uses to file its income tax return for the period covered by the financial statements. Individuals file Form 1040 (U.S. Individual Income Tax Return). Accordingly, the authors believe that personal financial statements prepared on the basis of accounting used for federal income tax reporting should be prepared based on the requirements of that form.

The historical cost basis and the income tax basis of accounting both are based on historical costs. However, there is often a difference between the two methods, such as for impairment losses recognized under the historical cost basis that are not deductible for income tax purposes until they are realized or because the cash method is used for income tax reporting. While current income tax requirements for individuals deal primarily with the timing of revenue recognition, they also address the measurement of certain assets and liabilities.

Assets acquired other than by conventional purchase for historical cost basis financial statements were discussed earlier in this section. Such assets are valued differently for income tax basis financial statements. When property is

inherited by a surviving spouse in a community property state, the entire asset is revalued at the date of inheritance and, when property is gifted, the basis of the donor is transferred to the donee.

The amounts of many revenues and expenses do not differ significantly under either method. A presentation of taxable income may differ from a presentation of revenues and expenses prepared on the tax basis, however, because taxable income excludes tax-exempt income and nondeductible expenses, such as most living expenses.

The discussion below addresses some of the differences between using the historical cost basis and the income tax basis to prepare personal financial statements.

Accounting Methods. The IRS allows an individual to account for business and personal items using different accounting methods. Thus, an individual may use the accrual method for his or her business and the cash method for nonbusiness income and deductions. Furthermore, if the individual operates two or more distinct and separate businesses, he or she may choose a different accounting method for each, as long as it is consistently applied and clearly reflects income.

Most individuals use the cash receipts and disbursements method of accounting. However, the accrual method is required by the IRS to clearly reflect income when the production, purchase, or sale of merchandise is a material income-producing factor, regardless of whether inventory is actually on hand at year end. The Internal Revenue Code allows qualifying small business taxpayers who are otherwise required to use the accrual method to use the cash method if they have average annual gross receipts of $26 million or less (for 2020 and 2019 tax years). A hybrid method is permitted when taxpayers use the accrual method for purchases and sales and the cash method for other items of income and expense.

Notes Receivable. Under the income tax basis of accounting, individuals must use the specific charge-off method to deduct bad debt losses related to business and nonbusiness receivables. A *business* bad debt can be either partially or totally worthless. If the individual can collect some, but not all, of the receivable, the portion of receivable for which collection efforts have been exhausted can be charged to expense. A *nonbusiness* bad debt is deductible only in the year it becomes totally worthless, however. Uncollectible receivables should not be charged to expense in income tax basis financial statements until they meet the IRS requirements for deductibility. That differs from GAAP requirements to provide an allowance for receivables that probably will not be collected.

Business Interests. Investments in S corporations and partnerships are generally reported using the equity method. Application of the equity method for tax reporting purposes may differ from the historical cost basis and from GAAP, which would require the investment to be recorded at its current value. For income tax basis financial statements, the underlying earnings of the investee are determined using the tax basis of accounting.

Investments in closely held C corporations are carried at cost in income tax basis financial statements. That differs from the historical cost basis of accounting, which recognizes the original cost of the investment plus the equity in undistributed earnings. Earnings are recognized in income tax basis financial statements only as distributions are received.

Income Taxes Payable. In the authors' opinion, individuals using the income tax basis of accounting to prepare personal financial statements should measure and accrue income taxes based on taxable income, even when the cash method is used for income tax reporting purposes. Because the income tax basis measures revenues and expenses in conformity with income tax rules, there are no temporary differences in recognizing taxable income. Accordingly, neither the deferred method of measuring income taxes for GAAP purposes prescribed by FASB ASC 740-10, nor the consideration of deferred income taxes for historical cost purposes, applies to individuals using the income tax basis of accounting for financial statement reporting purposes.

Considerations for Prescribed Form Engagements

Many personal financial statements are presented on preprinted forms supplied by a credit agency, bank, or other organization. Typically, many of the measurements and disclosures called for by those forms comply with GAAP. For example, forms typically ask that assets be shown at their current value and ask for information about assets and liabilities, such as the payment terms of debt. Nevertheless, the forms may be silent about the need for other

disclosures, such as disclosure of the use of current values. (In addition, the forms often ask for supplemental information, such as the major sources of receipts and the major categories of expenses.)

As discussed earlier in this lesson, a prescribed form engagement presents the financial statements on a preprinted form designed by the body using the statements. Such forms may not call for GAAP measurements or disclosures. *PPC's Guide to Compilation and Review Engagements* provides further guidance when financial statements are presented using prescribed forms.

Disclosure Considerations

Basis of Accounting. AU-C 800 states that audited financial statements should disclose the basis of accounting used to prepare the financial statements and describe how that basis differs from GAAP. (This requirement is also included in the SSARS for compilation and review engagements.) Neither the authoritative guidance in the auditing standards nor the SSARS require the differences between the special purpose framework and GAAP to be quantified in the disclosure. In addition, only significant differences need to be described. The authors believe the disclosure only needs to address the substance of the differences between the bases; thus, a detailed discussion of the GAAP treatment of an item is unnecessary. Normally, individuals present the disclosure of the basis of accounting as the first note to the financial statements using a heading such as "Basis of Accounting."

The following illustrates an example basis of accounting disclosure when the historical cost basis of accounting is used:

> NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
>
> Basis of Accounting
>
> Michael and Deborah Barton prepare their financial statements on the historical cost basis of accounting. The results under that basis differ from those under accounting principles generally accepted in the United States of America primarily because the investments in rental real estate are reported at their depreciated cost rather than at their current values.

The following illustrates an example basis of accounting disclosure when personal financial statements are prepared on the income tax basis of accounting:

> NOTE A—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
>
> Basis of Accounting
>
> Michael and Deborah Barton prepare their financial statements on the basis of accounting used for federal income tax purposes. This basis differs from accounting principles generally accepted in the United States of America primarily because assets are not adjusted to their current values.

Other Disclosures. FASB ASC 274-10-45-13 requires that personal financial statements include sufficient disclosures to make the statements adequately informative. The required disclosures may be made in the body of the financial statements or in the notes to the financial statements. AU-C 800 and the SSARS state that special purpose financial statements should either follow the relevant GAAP disclosure requirements or provide information that communicates the substance of those requirements.

Disclosures required by FASB ASC 274-10-50-2 that are generally considered necessary in special purpose personal financial statements include, but are not limited to—

a. Identification of the individuals covered by the statements.

b. That assets are presented at their estimated current values, and liabilities are presented at their estimated current amounts.

c. Either (1) the methods used in determining the estimated current values of major assets and the estimated current amounts of major liabilities or (2) the methods used in determining the major categories of assets and liabilities.

d. Changes in the methods discussed in c. above from one period to the next.

e. Description of the nature of joint ownership for property held jointly by the individual and other parties.

f. If the individual's investments are material and are concentrated in one or a few industries, the names of the companies (or industries) and the estimated current value of the securities or investments.

g. At least the following information regarding material investments in closely held businesses:

   (1) The name of the company and the individual's percentage of ownership.

   (2) The nature of the business.

   (3) Summarized financial information about assets, liabilities, and results of operations for the most recent year based on the financial statements of the business, including information about the basis of presentation (for example, generally accepted accounting principles or income tax basis) and any significant loss contingencies.

h. Description of intangible assets and their estimated useful lives.

i. The face amount of the life insurance the individuals own.

j. Description of nonforfeitable rights that do not meet the requirements for recording in the financial statements (e.g., a pension based on life expectancy).

k. The following tax information:

   (1) The methods and assumptions used to compute the estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases.

   (2) A statement that the income tax provision will probably differ from the amounts of income taxes that might eventually be paid because those amounts are determined by the timing and the method of disposal, realization, or liquidation, and the tax laws and regulations in effect at the time of disposal, realization, or liquidation.

   (3) Unused operating loss and capital loss carryforwards.

   (4) Other unused deductions and credits with expiration periods, if applicable.

   (5) The differences between the estimated current values of major assets and the estimated current amounts of major liabilities or categories of assets and liabilities and their tax bases.

   (6) The excess or deficit of the estimated current values of major assets or categories of assets over their tax bases.

l. Maturities, interest rates, collateral, and other pertinent details relating to receivables and debt.

m. Noncancelable commitments that do not have all of the characteristics required for recording in the financial statements.

In addition to the disclosures in the previous paragraph, other disclosures required by GAAP that are relevant to personal financial statements also should be considered, e.g., related-party transactions, pledged assets, certain contingencies, subsequent events, and lease information (including automobile leases).

The authors recommend that personal financial statements prepared using a special purpose framework include all notes necessary for adequate disclosure. The accountant may want to discourage clients from requesting compiled

financial statements without notes because most personal financial statement are intended for use by credit grantors who are not informed about such matters.

Reporting on Personal Financial Statements

The form and substance of compilation, review, or audit reports issued in connection with personal financial statements prepared in accordance with a special purpose financial reporting framework do not differ from such reports issued for commercial entities. Nevertheless, there are subtle differences in wording caused by the nature of the engagement. For instance, financial statement titles differ from those used for commercial enterprises. In addition, reports on personal financial statements identify the individuals (rather than the company) about whom the financial statements are prepared. Furthermore, such reports note that the representations are those of the individuals instead of management of a company.

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 personal financial statement scenarios correctly presents the appropriate information?

    a. Presentation 1 is prepared for one member of a group of joint owners and includes all assets of the group.

    b. Presentation 2 classifies assets and liabilities as current and noncurrent on the statement of financial condition.

    c. Presentation 3 is prepared on the modified cash basis to report certain assets and liabilities other than cash.

    d. Presentation 4 includes a statement showing results of changes in the individual's net worth as results of operations.

20. Which of the following statements best describes use of the historical cost basis for personal financial statements?

    a. Assets acquired with cash should be recorded at fair value on the date the financial statements are prepared.

    b. Property acquired by gift should be recorded at the property's fair value when the gift was made.

    c. Cash balances should include only the liquid cash available in the individual's checking account.

    d. Material business interests should be combined with the individual's personal investments.

21. The following individuals prepare their personal financial statements using the income tax basis of accounting. Which one has correctly addressed an aspect of using this basis of accounting?

    a. Lucy prepares her financial statements based on the requirements for Form 990.

    b. Manuel uses the accrual method for business income and the cash method for nonbusiness income.

    c. Nellie deducts partial amounts for both business and nonbusiness bad debts.

    d. Oliver reports investments in S corporations and partnerships using the historical cost basis.

SELF-STUDY ANSWERS

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

19. Which of the following personal financial statement scenarios correctly presents the appropriate information? **(Page 190)**

    a. Presentation 1 is prepared for one member of a group of joint owners and includes all assets of the group. [This answer is incorrect. When personal financial statements are prepared for only one of a group of joint owners of assets (or when additional statements are prepared for each individual owner), only the share that the individual has a right to as a beneficial owner under the property laws of the state should be included as part of the individual's assets.]

    b. Presentation 2 classifies assets and liabilities as current and noncurrent on the statement of financial condition. [This answer is incorrect. The basic objective of the statement of financial condition is to present at a point in time an individual's assets and liabilities at their current value, with the difference between assets and liabilities shown as net worth. It is a balance sheet type of presentation. Classifying assets and liabilities as current and noncurrent is not appropriate because an individual's financial affairs do not usually involve an operating cycle. Thus, FASB ASC 274-10-45-7 recommends that assets and liabilities be shown in order of liquidity and maturity.]

    c. **Presentation 3 is prepared on the modified cash basis to report certain assets and liabilities other than cash. [This answer is correct. Personal financial statements may be prepared on an accounting basis that satisfies the definition of a special purpose framework found in AU-C 800 and the SSARS. Such special purpose framework statements may result in personal financial statements that are prepared on one of the following bases: (1) cash, (2) modified cash, (3) tax, and (4) historical cost. Under the modified cash basis, the pure cash basis is modified to report certain assets and liabilities, generally at the amounts that would be reported under either the historical cost basis or the current value basis.]**

    d. Presentation 4 includes a statement showing results of changes in the individual's net worth as results of operations. [This answer is incorrect. The personal affairs of individuals do not constitute a business enterprise. Therefore, a statement presenting results of operations is not a basic personal financial statement. Instead, the statement of changes in net worth presents the major sources of increases and decreases in the individual's net worth for a period of time.]

20. Which of the following statements best describes use of the historical cost basis for personal financial statements? **(Page 193)**

    a. Assets acquired with cash should be recorded at fair value on the date the financial statements are prepared. [This answer is incorrect. Assets acquired by conventional purchase (by using cash or incurring a related debt such as a mortgage payable) should be recorded in historical cash basis personal financial statements at their original cost.]

    b. **Property acquired by gift should be recorded at the property's fair value when the gift was made. [This answer is correct. Personal financial statements often include assets acquired other than by conventional purchase. Cost for property acquired by gift should be the fair value of the property at the time of the gift.]**

    c. Cash balances should include only the liquid cash available in the individual's checking account. [This answer is incorrect. Cash balances should include cash in all bank accounts, including individual checking or savings accounts. It may also include cash balances in a brokerage account. Alternatively, brokerage account cash balances could be included as a separate item after cash.]

    d. Material business interests should be combined with the individual's personal investments. [This answer is incorrect. Business interests that constitute a large part of the individual's total assets should be shown separately from other investments.]

21. The following individuals prepare their personal financial statements using the income tax basis of accounting. Which one has correctly addressed an aspect of using this basis of accounting? **(Page 196)**

    a. Lucy prepares her financial statements based on the requirements for Form 990. [This answer is incorrect. AU-C 800.07 and AR-C 60A.07 describe the income tax basis as the basis of accounting an entity uses to file its income tax return for the period covered by the financial statements. However, individuals file Form 1040 (not Form 990).]

    b. **Manuel uses the accrual method for business income and the cash method for nonbusiness income. [This answer is correct. The IRS allows an individual to account for business and personal items using different accounting methods. Thus, an individual may use the accrual method for his or her business and the cash method for nonbusiness income and deductions.]**

    c. Nellie deducts partial amounts for both business and nonbusiness bad debts. [This answer is incorrect. Under the income tax basis of accounting, individuals must use the specific charge-off method to deduct bad debt losses related to business and nonbusiness receivables. A business bad debt can be either partially or totally worthless. A nonbusiness bad debt is deductible only in the year it becomes totally worthless, however. Therefore, Nellie cannot treat both types of bad debt the same when using this basis of accounting.]

    d. Oliver reports investments in S corporations and partnerships using the historical cost basis. [This answer is incorrect. Investments in S corporations and partnerships are generally reported using the equity method. Application of the equity method for tax reporting purposes may differ from the historical cost basis and from GAAP, which would require the investment to be recorded at its current value.]

REPORTING ON PROFESSIONAL SERVICE ENTITIES

Professional service entities are often ideal candidates for cash or income tax basis financial statements. Many professional service entities do not have significant third-party users such as banks or public shareholders, and do not need GAAP financial statements. Cash and income tax basis statements are consistent with how professionals manage their businesses, give them the information that they need to manage the practice, and may be more easily understood.

General Considerations

Characteristics. The characteristics distinguishing professional service entities, which are also referred to as licensed professional practices, from other businesses are as follows:

a. *State Licensure.* Most professionals have one or more licenses to practice granted by a licensing authority. The authority is usually a regulatory body either operated within a state government or officially sanctioned by a state. Licensed professional practices generally may be owned only by individuals holding a state-approved license.

   In addition to an ownership requirement, the state licensure laws typically restrict certain procedures or professional acts to those who have current state licenses. Thus, while professional practices typically employ both licensed and unlicensed individuals, only licensed professionals may perform certain services (for example, only a licensed physician may perform surgical procedures and prescribe drugs, only a licensed attorney may draft legal documents and represent another party in a court proceeding, etc.).

b. *Personal Liability.* In granting licensure, the state generally will also require that licensed professionals bear the personal responsibility for their own malpractice or misconduct. Thus, a second hallmark of a licensed occupation is that professionals cannot shield their personal assets from liability created by their own professional negligence, malpractice, or other personal wrongdoing by operating within a corporate or other limited liability entity. However, it is possible to limit personal liability from the professional errors or misconduct of colleagues who operate within the same business entity.

c. *Professional Goodwill.* The value of a professional practice often includes professional goodwill. While businesses in many industries build goodwill in the form of an established customer base, a recognized name and location, and similar attributes, a professional practice may have much of its goodwill attributable to the skills, reputation, and efforts of one or more individuals. This professional goodwill may have little value to a buyer and may expire with the death, disability, or retirement of the individual. This characteristic can create problems in valuing professional practices.

The licensed occupations that typically meet the criteria discussed in the previous paragraph can generally be grouped into six fields: (a) doctors, dentists, and similar health care professionals; (b) attorneys; (c) certified public accountants and other state-licensed accounting practitioners; (d) engineers; (e) architects; and (f) actuaries. The definition of licensed professional services can be expanded beyond those six occupations. However, from a tax standpoint, those six professions, along with consultants and performing artists, are the groups to which the personal service corporation restrictions apply.

In this section, the authors focus on issues common to those six fields of licensed professionals. Certain recognition, measurement, and presentation issues that are unique to a profession are also noted.

Forms of Entities. Professional groups are often organized in one of the following basic types of entities—sole proprietorships, partnerships, C corporations, S corporations, and in many states, limited liability companies (LLCs) or limited liability partnerships (LLPs). Professional groups may also be organized as professional service corporations (PSCs). A complete discussion of forms of entities is beyond the scope of this course. However, since PSCs are unique to entities providing professional services, and since LLCs are an increasingly popular choice for professional service entities, the following includes a brief discussion of those two forms of entities:

- *Personal Service Corporations.* In the broadest sense, a PSC is a corporate entity whose shareholder-employees perform personal services. Unfortunately, PSCs are defined differently (sometimes broadly,

sometimes narrowly) in various parts of the Internal Revenue Code. No single uniform definition of personal service corporations exists, and the use of the term depends on the context.

In other words, a corporation may be designated a personal service corporation for one tax purpose but not a personal service corporation for another purpose. For example, a corporation may be designated a PSC for purposes of determining its tax rate (which is a flat federal tax rate of 21% on taxable income), but it may not meet the definition of a PSC for purposes of the year-end conformity rules (i.e., the availability of noncalendar fiscal years).

Although tax legislation has reduced the attractiveness of this form of entity, many existing PSCs have decided that it is still in their best interests to remain in the corporate form. PSCs are discussed in more detail in *PPC's Specialized Industry Tax Guide* and *PPC's Guide to Physicians and Other Health Care Professionals*.

- *Limited Liability Companies.* LLCs combine the limited liability of a corporation with the flow-through of income, deductions, and credits of a partnership. All states have adopted LLC statutes and each state law is unique.

  Many states allow doctors, attorneys, accountants, and other professionals to form LLCs to conduct their practices. However, other states' statutes are silent as to whether professionals can use LLCs. Under the statutes that permit professionals to use LLCs, the LLC generally is liable for the wrongful or negligent acts of its members, and the members are personally liable only for their own wrongful or negligent acts. Thus, the use of an LLC does not completely eliminate a professional's liability concerns.

  Some states that do not allow professionals to form LLCs do allow them to form limited liability partnerships (LLPs). LLPs sometimes provide less liability protection than LLCs but provide more liability protection than general partnerships. LLCs and LLPs are discussed further in *PPC's Guide to Compilation and Review Engagements*.

Considerations for Pure Cash Basis Financial Statements

Under the pure cash basis of accounting, transactions are recorded only when cash is collected or paid. Its use results in measuring only one asset: cash; and no liabilities. For example, client fees are recorded when payment is received, not when service is provided, and cash purchases of office equipment are reflected as expenditures, not assets, when paid.

Considerations for Modified Cash Basis Financial Statements

Professional service entities may use a modified cash basis of accounting. However, the authors have found that some professional service entities requesting modified cash basis financial statements typically use the cash basis for income tax reporting and are really looking for financial statements prepared on that basis. Using that basis avoids the need for special considerations as to whether the modified cash basis is consistent with the way the entity is operated and if so, which modifications are appropriate.

If the entity elects to use the modified cash basis, the authors recommend using only those modifications that are consistent with the cash orientation of operations. Some of the more common modifications for a professional service entity are discussed in the following paragraphs.

Receivables. Professional service entities often have trade and nontrade receivables related to their businesses. Trade receivables typically represent claims for services that the entity has provided in the ordinary course of business (that is, fees that have not been collected). Nontrade receivables usually consist of receivables that have not originated as part of the operating cycle (such as receivables from sales of equipment or loans that the entity has made to other parties).

The authors believe recording fees on the accrual basis and reflecting related trade receivables is inconsistent with the cash orientation portrayed by the modified cash basis. Normally, receivables are recognized in modified cash basis financial statements only when there is an outflow of cash such as a loan to an employee. Thus, the authors

believe it may be appropriate for nontrade or notes receivable, which are usually supported by note agreements, to be reflected in modified cash basis statements similar to the treatment of long-term debt.

Historically, GAAP required the use of an incurred loss methodology to determine the credit loss estimates. ASU 2016-13 requires the use of an expected loss methodology to determine credit losses, also known as current expected credit losses (CECL). CECL can affect the accounting for entities preparing GAAP basis financial statements. However, most entities using special purpose frameworks for their financial statements will not be affected by CECL as trade receivables are normally not recognized in modified cash basis financial statements.

Professional service entities often have receivables from related parties, such as employees or stockholders. Consistent with the treatment of nontrade or notes receivable, the authors believe that it may be appropriate to reflect related party receivables in modified cash basis financial statements. Such receivables should be either segregated on the statement of assets, liabilities, and equity, or separately disclosed in the notes to the financial statements. That note can be presented separately or combined with other disclosures of related party transactions. The disclosures for loans receivable required by FASB ASC 310-10-50 should be made, or information that communicates the substance of those requirements should be provided.

Work in Process. Work in process represents professional services that have been rendered to a client but not billed. Under GAAP, work in process is recorded as an asset and reduced when the client is billed. The authors believe that recording work in process is inconsistent with the cash orientation of the modified cash basis and should not be reflected in modified cash basis financial statements.

Property and Equipment. Professional service entities often have office equipment, leasehold improvements, and automobiles that are used by the professionals within the firm. Doctors, dentists, and other health care professionals may also purchase medical equipment for use in their practices. If an entity decides to record acquisitions of property and equipment, the authors believe that the entity should capitalize all such additions. Amounts capitalized should include the amount financed as well as the down payment. In addition, the assets should be depreciated over their useful lives.

Debt. A frequent modification to cash basis financial statements is to record liabilities for borrowings and the related interest expense. If the financial statements include that modification, the terms of the debt agreements should be disclosed in the cash basis financial statements modified to record the debt.

Professional service entities may also have notes payable to related parties, such as professionals in the business. Those related-party transactions should be separately identified in the financial statements or appropriately disclosed in the notes to the financial statements.

Employee Benefit Plans. Another common modification to the cash basis relates to contributions to employee benefit plans. Many professional service entities have some form of defined benefit or defined contribution plan. Typically, the amount of contributions to employee benefit plans reflected in modified cash basis financial statements is the amount paid during the year, although entities sometimes modify their pure cash basis financial statements to accrue contributions that will be paid for the year.

Unique Accounts for Law Firms and Architects. Certain unique accounts for law firms and architects included in financial statements prepared on the cash method for income tax reporting are discussed later in this section. Although the discussion focuses on treatment of those items under the income tax basis, accountants may find some of the guidance useful for modified cash basis statements as well. For example, in modified cash basis financial statements for a law firm, costs advanced on behalf of clients may be recorded as assets when paid. The asset would be reduced when the clients reimburse the costs.

Considerations for Income Tax Basis Financial Statements

AU-C 800.07 and AR-C 60A.07 define the *tax basis* as the basis of accounting an entity uses to file its tax return for the period of the financial statements presented. Accordingly, the authors believe professional service entities should base their tax basis financial statements on the requirements of the form they file [for example, Form 1065 (U.S. Partnership Return of Income) or Form 1120 (U.S. Corporation Income Tax Return)]. A significant advantage of the income tax basis for many professional service entities is that it eliminates the need to perform time-consuming

calculations of adjustments that would be required to prepare GAAP statements, but would not be useful in managing the business. Examples are adjustments to provide valuation allowances for unrealizable amounts due from third-party providers or for unrealizable amounts of work in process.

The discussion below addresses some areas that accountants often encounter when preparing tax basis financial statements for professional service entities. Where applicable, issues of particular relevance to one profession are noted. In addition, unique considerations for law firms and architects are discussed later in this section.

Accounting Methods. The IRC prescribes two overall methods of accounting—the cash method and the accrual method. Under the cash method, income is generally recorded in the year it is actually or constructively received, and expenses are generally deducted in the year they are actually paid or the property is transferred. Under the accrual method, income generally is reported in the year earned, and expenses are generally deducted in the year incurred. Thus, the income tax cash and accrual methods generally differ in when transactions are reported.

Professional service entities are generally engaged in the business of rendering services for a fee and as such have generally been entitled to use the cash method of accounting for income tax reporting purposes. Any entity (other than a tax shelter) that meets the Section 448(c) gross receipts test can use the cash method regardless of whether the purchase, production, or sales of merchandise is an income-producing factor. [The gross receipts test under IRC Sec. 448(c) is met if the taxpayer's average annual gross receipts for the three-year tax period before the testing year does not exceed $26 million or $27 million for tax years beginning in 2021 and 2022, respectively.]

Receivables. Under the accrual method for income tax reporting, entities must accrue receivables and reflect the related revenues in the income statement. In addition, entities must use the specific charge-off method to deduct bad debt losses related to notes receivable and accounts receivable. Under that method, uncollectible receivables are not charged to expense until reasonable collection efforts have been exhausted and they become worthless.

An exception to the use of the accrual method allows certain professional service entities to avoid recognizing income that will only result in a future bad debt deduction. This exception, the nonaccrual experience method (NAE), is available to professional service entities that are either (a) in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or (b) meet the gross receipts test under IRC Sec. 448(c), discussed above. Under this method, an accrual-basis taxpayer is not required to accrue amounts to be received from the performance of qualified services that, based on experience, will not be collected. (This method cannot be used if interest is charged on amounts due or if there is a penalty for failure to pay on time.) The amount that does not have to be accrued is computed by using the revenue-based moving average method or one of the other safe harbor methods, which are described in detail in Reg. 1.448-3(f). When the receivable is collected, any amount that was not initially expected to be collected (i.e., the amount not accrued) must be taken into income. GAAP requires the use of an expected credit loss methodology for recognizing credit losses under CECL, which may result in a different accrual amount.

Under the cash method for income tax reporting, trade receivables are usually not recognized. However, as previously discussed, professional service entities may have notes receivables from related parties. If material, such receivables should be either segregated on the statement of assets, liabilities, and equity, or disclosed in the notes to the financial statements. That note can be presented separately or combined with the disclosure of other related-party transactions. The disclosures for loans receivable required by FASB ASC 310-10-50 should be made, or information that communicates the substance of those requirements should be provided.

Work in Process. Under the accrual method for income tax reporting, entities should recognize work in process, which represents professional services or professional hours that have been rendered to a client but not billed. As mentioned earlier, under the cash method for income tax reporting, work in process would not be recognized.

Prepaid Assets. Under the accrual method, one commonly prepaid item reflected on a professional service entity's statement of assets, liabilities, and equity is insurance, particularly malpractice or errors and omissions insurance premiums. In addition, some professional service entities, such as medical practices, may also have supplies that are included in prepaid or other assets.

Under the cash method, expenses such as insurance and supplies would generally be expensed when paid.

Retainers and Deferred Revenue. Many types of professional practices collect retainers from clients in advance of beginning an engagement. For example, an obstetrician may collect an advance fee for the sequence of care from the prenatal stage through delivery of the baby. Similarly, an accountant may establish a retainer with a medical practice client for accounting, tax and consulting services to be performed during the year.

Law firms frequently secure substantial retainers. Such retainers can be specific or annual. A specific retainer is an agreed-upon fee for a particular case, often one involving criminal work, bankruptcy, or divorce. Annual retainers, often used for corporate clients, are also agreed-upon fixed fees that cover services such as producing annual corporate minutes and advice on business matters over a specified period of time. Part or all of the retainer may be payable in advance.

Under the accrual method for income tax reporting purposes, a retainer is typically recognized as a liability in the statement of assets, liabilities, and equity. That liability is typically labeled as deferred revenue. Income would not be recognized in the statement of revenues and expenses until it is earned.

Under the cash method for income tax reporting, income from retainers would not be deferred. A law firm on the cash method of accounting that has free access to client retainer funds is taxable on the funds from the retainer when received. Accordingly, those amounts should be reflected as fee income in the statement of revenues and expenses. The authors believe that guidance can be applied to retainers for any type of professional service entity if the entity has free access to client funds.

Law Firms. The following are some additional measurement and presentation issues specifically for tax basis financial statements of law firms:

- *Trust Accounts.* An account that is peculiar to practicing attorneys is the trust fund or escrow account. Law firms may have many separate trust accounts. The law firm will deposit into that account funds it receives from a client that are to be disbursed to various third parties, and sometimes to the law firm itself for fees earned. Typically, those funds represent proceeds from settlement of law cases and deposits received from real estate closings.

  Once a case is settled, the attorney's fee is determinable and should be included in income. (This position has been supported by the courts.) Therefore, funds in the trust account that represent fees that have been earned on settled cases should be recognized as income in tax basis financial statements.

  The trust fund may also contain a specific retainer, which represents an agreed fee for a particular case that has been received in advance. Cases involving criminal work, bankruptcy, and divorce often involve the collection of a retainer. A retainer is generally thought of as an agreed-upon fee received in advance. Retainers typically are deposited into a trust or escrow account and then transferred to the law firm's general account as the retainer is earned through the rendering of services by the attorney. The IRS's position is that a law firm on the cash method of accounting that has free access to client retainer funds should include retainers as income when received. However, if the retainer in the trust fund is restricted (in other words, "free access to client retainer funds" is not present), the funds are not considered income when received.

  Trust accounts may also be used to collect contingent fees. A law firm will often accept a personal injury case under a contingent fee arrangement, which provides that the firm receives a share, generally one-third, of the ultimate recovery upon litigation or settlement. When the settlement is received, it is deposited to the attorney's trust account, any expenses that have been advanced by the law firm are reimbursed, and the remaining proceeds, after the attorney's fee, are distributed to the client. (Amounts paid to the attorney from the trust account that do not represent advanced costs are included in the attorney's gross income on the statement of revenues and expenses.) The treatment of client expense advances is discussed in the next bullet.

- *Client Expense Advances.* Law firms commonly pay litigation expenses on behalf of their clients. Those costs are then recovered by the professional service entity when the settlement or court award is received. That practice is typically applied by firms that accept cases on a contingency basis, such as in the litigation of personal injury claims. In some cases, it may take several years to resolve a case. Meanwhile, a law firm

may have advanced substantial costs in anticipation of collecting a percentage share of the settlement or court award at some future time.

The use of the cash basis of accounting can distort income because advanced funds and expenses may be incurred by the law firm several years ahead of settling the case and receiving the offsetting revenue or reimbursement. Accordingly, the courts have held that litigation costs and other expenses advanced by an attorney, where the client is unconditionally responsible to reimburse the attorney, do not represent deductible business expenses when incurred but rather must be treated as loans to the client. Therefore, they are typically reflected on the statement of assets, liabilities, and equity and labeled with a caption such as advanced costs. If the law firm is not successful in receiving reimbursement from its client, it can deduct the expenses incurred as a bad debt when it determines that worthlessness of the loan has occurred.

If a law firm incurs expenses on behalf of a client that it initially treats as a loan but later decides that it will not bill the client and will not seek reimbursement, the unreimbursed costs may be deductible as a business expense (assuming that there is a valid business purpose for not billing the client). Valid business purposes for not billing the client may exist when the client has received insufficient benefit for the out-of-pocket expense incurred or when the amount is so small in relation to other billings to the client that the attorney chooses to write off the out-of-pocket expense.

Architects. The following are some measurement and presentation issues specifically for tax basis financial statements of architects:

- *Client Expense Advances.* Architects may also incur and pay expenses on behalf of the client. The existence of those items will be spelled out in the contract and include items like transportation, travel, fees for securing approvals required for projects, blueprint copies, postage, etc. If the firm also performs interior design work, then the size of the reimbursable expenses typically will increase greatly. According to the most recently issued IRS Audit Technique Guide on architects (revised August 2011 and available on the IRS's website at **www.irs.gov/pub/irs-utl/architects_atg.pdf**), those reimbursable expenses are essentially loans to the client. Accordingly, an asset account should be reflected on the statement of assets, liabilities, and equity for those expense advances.

- *Performance Guarantees.* Architects sometimes have a liability for performance guarantees from contractors. Contractors who bid on construction projects designed by an architect may be required to deposit performance guarantees with the architect as security for blueprints and specifications used to make the estimates. The deposits are returnable to the contractor when the performance is completed, and accordingly the architect should report the deposit as a liability. Consequently, the return of the deposit is not an expense.

Disclosure Considerations

Basis of Accounting. AU-C 700.12–.17 require an evaluation of whether the audited financial statements achieve fair presentation. AU-C 800 provides guidance on what constitutes fair presentation for special purpose financial statements. Among other things, it states that special purpose financial statements should disclose the financial reporting framework used to prepare the statements and describe how the framework differs from GAAP. (The effects of these differences need not be quantified.) In addition, only significant differences need to be described. For example, if a professional service entity has significant deferred compensation agreements, that could represent a difference between the income tax basis and GAAP that should be disclosed, as discussed later in this section. The authors believe that the disclosure of differences between the special purpose framework and GAAP only needs to address the substance of the differences between the bases; thus, a detailed discussion of the GAAP treatment of an item is unnecessary. Normally, professional service entities present the disclosure of the basis of accounting as the first note to the financial statements using a heading such as "Basis of Accounting."

Significant Accounting Policies. Special purpose financial statements should disclose the significant accounting policies used to prepare them. Significant accounting policies include those for which there is a selection from existing acceptable alternatives, principles and methods peculiar to the industry in which the entity operates, and unusual or innovative applications of the special purpose framework. A professional service entity may wish to

disclose any accounting policies used that are peculiar to the industry. For example, a law firm may disclose its policy for accounting for client advances, as previously discussed.

Although not required, if the entity is a pass-through entity such as an S corporation, partnership, LLC, LLP, or sole proprietorship, the authors believe that a disclosure in the summary of significant accounting policies should indicate the filing status and explain why income taxes are not reflected.

Frequent disclosures included for professional service entities under the summary of significant accounting policies include nature of operations, depreciation methods, use of estimates, and date of management's review for subsequent events.

Significant Concentrations of Risk. The authors believe that information on significant concentrations of risk is relevant to all cash, modified cash, and income tax basis presentations. Therefore, information should be disclosed to alert financial statement readers to the reasonable possibility that the loss of a significant customer, supplier, or other concentration will have a severe impact on the entity. For professional service entities, one example of that concentration of risk may occur when the entity has a significant customer or client. For example, an attorney may perform a significant amount of work for one client. For physicians, such risk may occur if a significant amount of income is received from one insurance company, or one government agency, such as Medicare. Such concentrations should be disclosed if they meet the criteria of FASB ASC 275-10-50-16. FASB ASC 275-10-50-16 through 50-22 does not require that the effect of the concentration be quantified. Instead, the significance of the concentration can be conveyed through estimated percentages, a ratio, or adjectives.

Certain types of professional service entities may also be more closely linked to the general health of the economy in the region in which they operate. For example, an architect may find that his business improves when the local community itself is thriving, and suffers when the regional economy takes a downturn. Again, that type of effect may be significant, and if so, should be disclosed in the notes to the financial statements.

Related-party Transactions. As previously mentioned in this section, professional service entities often enter into agreements or transactions with related parties. Common related-party transactions include notes receivable from employees or stockholders, notes payable to stockholders, and leasing arrangements with related parties. If those transactions are significant, they should be disclosed. FASB ASC 850-10-50-1 defines *related parties* for which it requires disclosures in GAAP financial statements and presents the required disclosures for related-party transactions. Disclosures in special purpose financial statements may substitute qualitative information for some of the quantitative information required by GAAP or may provide information that communicates the substance of those requirements. Therefore, the substance of the disclosure requirements found in FASB ASC 850-10-50-1 can be communicated in special purpose financial statements in ways other than disclosing the dollar amounts.

Some accountants preparing tax basis financial statements may wish to disclose related-party transactions based on the definitions included in the IRC rather than the definition included in FASB ASC 850-10-50-1. If the definitions in the IRC are used to determine related parties for note disclosure purposes, the authors believe that policy should be disclosed as a difference between the tax basis and GAAP basis in the summary of significant accounting policies.

Commitments and Contingencies. Accountants should disclose material commitments and contingencies in the financial statements of professional service entities. One contingent liability commonly found in professional service practices arises from negligence or malpractice lawsuits or claims. Although the special purpose financial statements may not reflect an accrued loss related to the contingency (for example, contingencies cannot be recorded in income tax basis financial statements), the disclosures that would be required by FASB ASC 450-20-50 may be necessary to keep the special purpose financial statements from being misleading.

Professional service entities may also have commitments that require disclosure. One of the most common is a lease commitment, which is discussed below. Other common types of commitments include the following:

- *Buy/Sell Agreements.* Professional service entities that are organized as corporations often have buy/sell agreements with stockholders. Those agreements ordinarily specify how stock will be distributed should a stockholder die or otherwise choose to leave the practice. In most states, for example, shares in a medical corporation can be transferred only to someone who is licensed to practice medicine. The existence of

such agreements should be disclosed; however, disclosure of the specific terms of the agreement is not required. An example of such a disclosure is as follows:

> NOTE H—BUY/SELL AGREEMENT
>
> The Corporation has entered into an agreement with both of its stockholders that obligates the Corporation, upon the death of the first of the two stockholders, to purchase the deceased stockholder's stock in the Corporation. The purchase price is established by formula and is partially insured.

- *Deferred Compensation Agreements.* Professional service entities may also have deferred compensation agreements with their employees or stockholders. For example, a professional medical corporation may have deferred compensation arrangements with its physicians that are structured to provide the physicians with compensation (based on a predefined formula) upon their termination for any reason. Such a formula may be designed to compensate a physician for those charges generated by the physician but not yet collected (that is, his or her portion of patient receivables). Under GAAP, benefits expected to be paid under a deferred compensation arrangement should be accrued and charged to earnings as the related service is rendered. In an income tax basis financial statement, deferred compensation is not recognized until paid. If that difference between GAAP and income tax basis is significant, it should be disclosed as discussed earlier in this section in the "Basis of Accounting" paragraph.

  An example of a disclosure for a deferred compensation agreement follows:

> NOTE I—COMMITMENTS
>
> The Corporation has entered into an unfunded deferred compensation agreement with each of its professional employees. Upon separation of service, these employees will receive an amount based on future collections of accounts receivable. Payments under these agreements will be over a six-month period following separation.

Terms of Lease Agreements. When special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, AU-C 800.18 and the SSARS indicate that informative disclosures similar to those required by GAAP are necessary to achieve fair presentation. Therefore, the terms of lease agreements should be disclosed in special purpose financial statements.

It is common for a professional service entity to lease office space in a building that is owned by one of the professionals or by a partnership in which the professionals may be partners. (When the professional service entity operates as an S or C corporation, there are significant tax reasons for not placing real estate, which may appreciate significantly, inside the corporation.) Consequently, in addition to the disclosures necessary for leases, the disclosures required for related-party transactions should also be included. Such disclosures can be made separately or combined with other disclosures of related-party transactions.

Supplementary Information on Accounts Receivable. Depending on the basis of accounting that the professional service entity uses, accounts receivable may not be reflected on the statement of assets, liabilities, and equity. If accounts receivable are not recognized, some professional service entities choose to provide supplementary information related to those amounts. That information may be helpful for professionals, particularly physicians, in managing their practices. For example, physicians need to carefully monitor receivables from patients and from third-party payors since there is a great deal of complexity associated with payments from private insurers, government regulated programs, and major national carriers. For professional service entities that use the modified cash basis or the cash method for income tax reporting purposes to prepare their financial statements, a supplemental schedule that summarizes charges, collections, accounts receivable balances, and production data for a practice can help in the management of the practice. It allows an owner to review important management data and identify trends that affect the practice's profitability. Accountants should report on supplementary information included with 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.

22. Which of the following is a distinguishing characteristic of a professional service entity?

    a. It typically needs at least one license to practice.

    b. It can only employ licensed professionals.

    c. It is designed to limit personal liability.

    d. Professional goodwill seldom factors into the entity's value.

23. Which of the following statements best describes a professional service entity that uses the income tax basis of accounting?

    a. The Internal Revenue Code requires the use of the accrual method for recording income and expenses.

    b. Preparing financial statements using the income tax basis is more time consuming than preparing GAAP statements.

    c. A specific charge-off method must always be used to deduct bad debt losses on receivables under the accrual method.

    d. Under the accrual method, work in process must be recognized by the entity.

24. Collins & Winters, a professional service entity, has a significant buy/sell agreement. Including information about this agreement in its special purpose financial statements will help fulfill its disclosure requirements for which of the following categories?

    a. Commitments and contingencies.

    b. Significant concentrations of risk.

    c. Related-party transactions.

    d. Terms of lease agreements.

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.)**

22. Which of the following is a distinguishing characteristic of a professional service entity? **(Page 204)**

    a. **It typically needs at least one license to practice. [This answer is correct. Most professionals have one or more licenses to practice granted by a licensing authority. The authority is usually a regulatory body either operated within a state government or officially sanctioned by a state. Licensed professional practices generally may be owned only by individuals holding a state-approved license.]**

    b. It can only employ licensed professionals. [This answer is incorrect. Professional practices typically employ both licensed and unlicensed individuals, but only licensed professionals may perform certain services.]

    c. It is designed to limit personal liability. [This answer is incorrect. Generally, states will require that licensed professionals bear the personal responsibility for their own malpractice or misconduct. Thus, such professionals cannot shield their personal assets from liability created by their own professional negligence, malpractice, or other personal wrongdoing by operating within a corporate or other limited liability entity.]

    d. Professional goodwill seldom factors into the entity's value. [This answer is incorrect. The value of a professional practice often includes professional goodwill. A professional practice may have much of its goodwill attributable to the skills, reputation, and efforts of one or more individuals. This professional goodwill may have little value to a buyer and may expire with the death, disability, or retirement of the individual. This characteristic can create problems in valuing professional practices.]

23. Which of the following statements best describes a professional service entity that uses the income tax basis of accounting? **(Page 207)**

    a. The Internal Revenue Code requires the use of the accrual method for recording income and expenses. [This answer is incorrect. The IRC prescribes two overall methods of accounting—the cash method and the accrual method. Professional service entities are generally engaged in the business of rendering services for a fee and as such have generally been entitled to use the cash method of accounting for income tax reporting purposes if they meet certain qualifications. Otherwise, they would use the accrual method.]

    b. Preparing financial statements using the income tax basis is more time consuming than preparing GAAP statements. [This answer is incorrect. A significant advantage of the income tax basis for many professional service entities is that it eliminates the need to perform time-consuming calculations of adjustments that would be required to prepare GAAP statements.]

    c. A specific charge-off method must always be used to deduct bad debt losses on receivables under the accrual method. [This answer is incorrect. An exception to the use of the accrual method allows certain professional service entities to avoid recognizing income that will only result in a future bad debt deduction. The entities must meet certain qualifications, like providing health services or meeting a certain level of gross receipts.]

    d. **Under the accrual method, work in process must be recognized by the entity. [This answer is correct. Under the accrual method for income tax reporting, entities should recognize work in process, which represents professional services or professional hours that have been rendered to a client but not billed. Under the cash method for income tax reporting, work in process would not be recognized.]**

24. Collins & Winters, a professional service entity, has a significant buy/sell agreement. Including information about this agreement in its special purpose financial statements will help fulfill its disclosure requirements for which of the following categories? **(Page 210)**

    a. **Commitments and contingencies. [This answer is correct. Accountants should disclose material commitments and contingencies in the financial statements of professional service entities. Common types of commitments professional service entities may have that require disclosure are lease commitments and buy/sell agreements.]**

    b. Significant concentrations of risk. [This answer is incorrect. Generally, information on significant concentrations of risk is relevant to all cash, modified cash, and income tax basis presentations. Therefore, information should be disclosed to alert financial statement readers to the reasonable possibility that the loss of a significant customer, supplier, or other concentration will have a severe impact on the entity. However, this is a different type of disclosure than the one described in this scenario.]

    c. Related-party transactions. [This answer is incorrect. Professional service entities often enter into agreements or transactions with related parties. Common related-party transactions include notes receivable, notes payable, and leasing arrangements. If those transactions are significant, they should be disclosed. However, based on the information provided in this scenario, the buy/sell agreement is not necessarily a related-party transaction; therefore, it will be disclosed in relation to a different category.]

    d. Terms of lease agreements. [This answer is incorrect. When special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, AU-C 800.18 and the SSARS indicate that informative disclosures similar to those required by GAAP are necessary to achieve fair presentation. Therefore, the terms of lease agreements should be disclosed in special purpose financial statements. However, this is a different type of disclosure than the one described in the scenario above.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting—Course 2—Reporting on Special Purpose Framework Financial Statements and Special Entities (OFSTG222)

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, fax, or mail 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
     OFSTG222 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 **October 31, 2023**. 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 Cash, Tax, and Other Bases of Accounting—Course 2—Reporting on Special Purpose Framework Financial Statements and Special Entities (OFSTG222)

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 should be included in the introductory paragraph of a review report?

   a. A statement that a review is higher in scope than an audit.

   b. The identity of the entity whose financial statements have been reviewed.

   c. A listing of management's responsibilities for the financial statements.

   d. The city and state where the accountant practices.

2. Woody, a CPA, is not independent with respect to Quest Apparel. What type(s) of report, if any, is Woody allowed to issue on Quest's financial statements?

   a. Woody may issue a compilation report, but not a review report, if he discloses his lack of independence.

   b. Woody may only issue an audit report because of his lack of independence.

   c. Woody may issue a review report, but not a compilation report, if he discloses his lack of independence.

   d. Woody is precluded from issuing any report due to his lack of independence.

3. When compiled special purpose financial statements omit substantially all disclosures, AR-C 80A.A31 indicates that such financial statements should include which of the following?

   a. A summary of significant accounting policies.

   b. A description of how the special purpose framework differs from GAAP.

   c. A paragraph concerning the basis of accounting.

   d. A note stating that one of the omitted disclosures is the accountant's lack of independence.

4. When performing a review engagement, if the accountant becomes aware of material measurement departures from the applicable financial reporting framework, what is the *preferred* course of action?

   a. Refer to the departure in a letter to the IRS.

   b. Withdraw from the engagement.

   c. Convince the client to revise the statements into conformity.

   d. Consider consulting legal counsel.

5. In a compilation report, which of the following is correct regarding an emphasis-of-matter or other-matter paragraph?

   a. It should reference the matter and where relevant disclosures can be found.

   b. It should be placed in the body of the accountant's report instead of in a separate section.

   c. It should refer to matters not disclosed or presented in the financial statements.

   d. It must state that the accountant's conclusion is not modified with respect to the matter.

6. Which of the following situations requires the use of a separate section in the review report instead of an additional, emphasis-of-matter, or other-matter paragraph?

   a. When a change in accounting principle has occurred.

   b. When proper tax treatment of transactions is clear and certain based on current tax law.

   c. When management's plans alleviate substantial doubt about the entity's ability to continue as a going concern.

   d. When after reviewing management's plans, substantial doubt remains about the entity's ability to continue as a going concern.

7. Which of the following statements is correct regarding an accountant restricting the use of his or her compilation or review report using an other-matter paragraph?

   a. An accountant is permitted to restrict the use of a report even if not required to do so by professional standards.

   b. The accountant will be responsible for controlling the distribution of any restricted-use reports he or she issues.

   c. As long as the restricted report indicates it is not intended for general use, specified parties do not need to be identified.

   d. Once the financial statements have been restricted and the engagement completed, other specified parties cannot be added.

8. How should the auditor modify the standard report if there is a scope limitation?

   a. Adverse opinion.

   b. Qualified opinion.

   c. Unmodified opinion.

   d. Other-matter paragraph.

9. How should the auditor modify the standard report if there is a pervasive departure from the special-purpose framework?

   a. Adverse opinion.

   b. Qualified opinion.

   c. Unmodified opinion.

   d. Other-matter paragraph.

10. Russell is performing an audit engagement for Feed & Seed. The client had a change in accounting principle that materially affects the comparability of the financial statements. How must Russell modify his auditor's report?

    a. Russell must qualify his opinion.

    b. Russell must issue an adverse opinion.

    c. Russell is not required to modify his report.

    d. Russell must include an emphasis-of-matter paragraph in a separate section.

11. If an auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, the auditor is required to do which of the following?

    a. Express the conclusion about substantial doubt in a separate section of the auditor's report.

    b. Present a section in the auditor's report with the heading "Restriction on Use."

    c. Use conditional language when expressing the conclusion about the substantial doubt.

    d. Repeat last year's going concern section even if substantial doubt has been removed this year.

12. If regulatory basis financial statements are to be used solely by the entity and regulatory agencies, the auditor can report on them as what type of financial statements?

    a. Contractual.

    b. Statutory.

    c. Personal.

    d. Special purpose framework.

13. Which basis of accounting is described by the auditing literature and the SSARS as an accounting basis used by an entity to comply with provisions of an agreement between the entity and other third parties (other than the auditor or accountant)?

    a. Contractual.

    b. Personal.

    c. Modified cash.

    d. Statutory.

14. Which of the following provides guidance on compiling or preparing financial statements based on a prescribed format?

    a. GAAP.

    b. AICPA Guide.

    c. The IRS.

    d. SSARS.

15. Personal financial statement compilations and reviews prepared in conformity with a special purpose framework, similar to other such engagements, are subject to which requirement(s) of the SSARS?
    a. Performance.
    b. Reporting.
    c. Performance and reporting.
    d. Disclosure.
16. In a compilation or review report issued on personal financial statements prepared under a special purpose framework, which of the following would be expected to differ from a similar report issued for a commercial entity?
    a. The form of the report.
    b. The substance of the report.
    c. The statement titles in the report.
    d. Both the form and the substance of the report.
17. If personal financial statements are intended primarily for obtaining credit, the client may decide to engage the accountant to either prepare the statements under AR-C 70A or compile them under AR-C 80A. According to the text, which of the following parties is/are generally involved in that decision?
    a. The client only.
    b. The accountant only.
    c. The accountant and the IRS.
    d. The creditor and the accountant.
18. Wheeled Meals, a nonprofit organization, has a controlling financial interest in Hunger's End, another nonprofit organization. How will this affect Wheeled Meals' financial statements?
    a. The financial statements do not require consolidation.
    b. The financial statements are required to be combined.
    c. The financial statements are required to be consolidated.
    d. The financial statements are required to be presented separately.
19. Which of the following statements regarding consolidated financial statements is correct?
    a. Deciding to consolidate or combine entities into a nonprofit's financial statements may depend on the basis of accounting used.
    b. Accountants are not allowed to present combined financial statements for two or more commonly controlled entities.
    c. FASB ASC 958-810-25-5 states that the existence of both an economic interest and control precludes consolidation.
    d. Deciding whether to present consolidated financial statements or not is decided by the client.

20. Which of the following nonprofit organizations has used a best practice recommended by this course related to use of the modified cash basis of accounting?

    a. World Alive capitalizes payments to purchase marketable securities and does not recognize or disclose donated securities.

    b. Change for Good capitalizes purchased property and equipment and discloses the amount of donated property and equipment.

    c. Olympus Home records unconditional promises to give as revenues using the accrual basis and does not reduce them for changes in the amount expected to be received.

    d. Real Progress omits disclosures about the classes of net assets since it is not presenting GAAP financial statements.

21. Which of the following statements best describes an issue that nonprofit organizations may face when using the income tax basis of accounting?

    a. Pledges receivable amounts will be the same as those measured under GAAP.

    b. Conditional grants should not be reported in tax basis financial statements.

    c. Organizations are required to follow FASB ASC 958 for income tax reporting purposes.

    d. Revenue from the sale of goods should not be deferred for tax purposes if received in advance.

22. World View, a nonprofit organization, uses the income tax basis of accounting. Since the IRS does not require organizations to follow FASB ASC 958 in reporting and recording contributions for income tax purposes, what difference from GAAP might its financial statements reflect related to contributions?

    a. It will be required to use the tax depreciation methods and rules that apply to for-profit entities.

    b. It can report contributions as increases in the appropriate fund balance rather than as an increase in the class of net assets.

    c. It is prohibited from reporting contributions with donor use restrictions to future years as deferred revenue.

    d. Treatment of all transactions would be the same whether or not the organization follows FASB ASC 958.

23. Which of the following bases of accounting is described as one in which an organization maintains records on a basis identical to, or substantially identical to, that needed to file grant reports?

    a. Cash basis.

    b. GAAP basis.

    c. Income tax basis.

    d. Regulatory basis.

24. As used in this course, the term *fiduciary financial statements* applies to which of the following?

    a. Professional service entities.

    b. Nonprofit organizations.

    c. Personal financial statements.

    d. Estates and trusts.

25. Financial presentations of an estate or trust generally are intended for which type of use?
    a. To apply for grants.
    b. To be issued to numerous third parties.
    c. To help in the settlement of the estate or trust.
    d. To apply for credit.
26. What is one of the most common ways that an estate or trust might modify the cash basis of accounting?
    a. Reporting certain liabilities on the accrual basis.
    b. Expensing noncash assets such as property and equipment.
    c. Withholding information about its debts.
    d. Identifying the statements as GAAP statements.
27. Which of the following forms is used to determine and report the estate tax liability of a decedent?
    a. Form 706.
    b. Form 990.
    c. Form 1040.
    d. Form 5500.
28. Agnes dies on August 15, 2022. For the purposes of determining fair market value of her assets, what is the alternate valuation date that her estate can use?
    a. November 15, 2022.
    b. December 31, 2022.
    c. January 1, 2023.
    d. February 15, 2023.
29. An accountant should recommend that the financial statements include certain note disclosures. Which of the following is considered a required disclosure?
    a. An explanation of the methods used to decide the current values.
    b. The financial reporting framework used and how it differs from GAAP.
    c. Disclosing new business prospects and the date on which the prospects were contacted.
    d. Disclosing major transactions having no effect on assets for which the fiduciary is accountable.
30. When a special purpose framework is used for basic personal financial statements, this course suggests that the term *financial condition*, normally associated with current value presentations, should be replaced with which of the following terms?
    a. Assets and liabilities.
    b. Net income.
    c. Results of operations.
    d. Liquidity and maturity.

31. When preparing personal financial statements using the modified cash basis, accountants generally choose one of two bases to measure the modifications. What are those two bases?

    a. Current value or pure cash basis.

    b. Historical cost or current value basis.

    c. Pure cash or historical cost basis.

    d. Fair value or current value basis.

32. Assuming all other conditions are met, a transaction is considered a future interest under the historical cost basis if the right to future sums is which of the following?

    a. An amount that is not easily determinable.

    b. Contingent on the holder's life expectancy.

    c. Not dependent on future services performed by the holder.

    d. Contingent on the holder's disability or death.

33. When preparing historical cost financial statements, what is the best response when the current value of an asset is less than the asset's historical cost?

    a. Record the value of the asset at the historical cost.

    b. Record the value of the asset at its current value.

    c. Change methods of accounting to one that will more accurately represent this asset.

    d. Recognize a loss for a decline in fair market value below amortized cost.

34. The income tax basis and the historical cost basis of accounting have which of the following in common in reference to personal financial statements?

    a. Impairment losses are deductible in the same manner.

    b. Both bases of accounting are based on historical costs.

    c. Assets acquired by nonconventional purchase are valued similarly.

    d. Investments in closely held C corporations are recognized the same way.

35. Personal financial statements prepared using a special purpose framework will likely need which of the following disclosures?

    a. That all assets are presented at their original value.

    b. The total of all used operating loss and capital loss carryforwards.

    c. The name of all companies the individual invested in.

    d. Identification of all individuals that the statements cover.

36. What is one reason that a professional service entity may be an ideal candidate for cash or tax basis financial statements?

    a. Their financial statements are typically used by significant third parties.

    b. Their financial statements are not typically used by third parties.

    c. They rarely have trade and nontrade receivables related to their businesses.

    d. Property and equipment assets do not need to be depreciated over their useful lives.

37. What type of professional group is broadly defined as a corporate entity whose services are provided by shareholder-employees?

    a. Personal service corporation.

    b. Limited liability company.

    c. C corporation.

    d. S corporation.

38. This course suggests that a professional service entity using the income tax basis of accounting would most likely tailor its financial statements to meet the requirements of which of the following?

    a. Related parties.

    b. The licensing authority.

    c. Its public shareholders.

    d. The tax form it files.

39. Morgan & Stoddard, a law firm, presents tax basis financial statements. Which of the following issues might affect this firm that would not affect a professional service entity practicing in another field?

    a. Accounting for client expense advances for blueprint copies.

    b. Accounting for a trust fund or escrow account.

    c. Accounting for performance guarantees.

    d. Accounting for prepaid assets, such as insurance.

40. Depending on the basis of accounting used by the professional service entity, accounts receivable may not be reflected on the financial statements. If accounts receivable are not recognized, how might some professional service entities choose to provide information related to those amounts?

    a. In a debt agreement.

    b. In the management data.

    c. As supplementary information.

    d. Using the revenue-based moving average method.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting—Course 2—Reporting on Special Purpose Framework Financial Statements and Special Entities (OFSTG222)

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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Course Title: Companion to PPC's Guide to Cash, Tax, and Other Bases of Accounting—Course 2—Reporting on Special Purpose Framework Financial Statements and Special Entities (OFSTG222)

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Satisfaction Level:	**Low (1) . . . to . . . High (10)**									
	1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
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GLOSSARY

Adverse opinion: Auditors give an adverse opinion when they conclude that misstatements, individually or in the aggregate, from the special purpose framework are both material and pervasive to the financial statements. Adverse opinions are rare in practice because their implications are so serious that they usually cause the company to correct the financial statements.

Carrying value: The value of the asset at the time the fiduciary acquired the asset.

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

Contractual basis: An accounting basis that is used by an entity to comply with the provisions of an agreement between the entity and other third parties (other than the auditor or accountant).

Current value basis: Under this basis of accounting, assets are presented at their estimated current values and liabilities are presented at their estimated current amounts. FASB ASC 274-10-35-1 establishes the estimated current value basis of accounting as GAAP for personal financial statements.

Disclaimer of opinion: A disclaimer of opinion states that the auditors are unable to obtain sufficient appropriate audit evidence on which to base the opinion on the financial statements and the auditors conclude that the possible effects of undetected misstatements, if any, could be both material and pervasive. Generally, auditors issue a disclaimer of opinion when they are faced with a scope limitation so significant that they believe a qualified opinion is not appropriate.

Emphasis-of-matter paragraph: 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.

Fiduciary acquisition value: The normal valuation basis for the assets of an estate or trust. The market value on the date assets are transferred to a fiduciary.

Fiduciary financial statements: The financial statements of estates and trusts, which are presented as an accountability of funds. Normally, they are intended to meet the requirements of a probate court or the beneficiaries of the estate or trust. The financial statements can be prepared using GAAP or a special purpose framework or be a special purpose presentation.

Historical cost basis: In reference to personal financial statements, the historical cost basis generally measures the individual's assets and liabilities based on the assets' and liabilities' original cost.

Income in respect of a decedent (IRD): Income to which the decedent was entitled but due to his or her death was not includible in taxable income.

Income tax basis: The basis of accounting that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.

Modified cash basis: Under this basis, the pure cash basis is modified to report certain assets and liabilities, generally at the amounts that would be reported under either the historical cost basis or the current value basis.

Net assets with donor restrictions: The portion of a nonprofit organization's net assets that is subject to donor-imposed restrictions.

Net assets without donor restrictions: The portion of a nonprofit organization's net assets that is not subject to donor-imposed restrictions.

Other information: Additional financial and/or nonfinancial information that accompanies the financial statements and the auditor's report thereon, excluding required supplementary information.

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.

Personal financial statements: Financial statements that present the personal assets and liabilities of an individual or group of related individuals (a family).

Personal service corporation (PSC): In the broadest sense, a PSC is a corporate entity whose shareholder-employees perform personal services. Unfortunately, PSCs are defined differently (sometimes broadly, sometimes narrowly) in various parts of the Internal Revenue Code. No single uniform definition of personal service corporations exists, and the use of the term depends on the context.

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

Regulatory basis: A basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject. Some nonprofit organizations maintain their accounting records on a basis identical to, or substantially identical to, that needed to file grant or regulatory reports.

Restricted use reports: Those intended only for one or more specified third parties.

Supplementary information: Information presented either as a stand-alone document or in conjunction with the basic financial statements, that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework.

Trust account: An account that is peculiar to practicing attorneys, the trust fund or escrow account is an account into which the law firm will deposit funds it receives from a client that are to be disbursed to various third parties, and sometimes to the law firm itself for fees earned.

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